بسم الله الرحمن الرحيم

IN THE NAME OF ALLAH,
MOST MERCIFUL, MOST COMPASSIONATE.

ISLAMIC BANKING IN AN INTEREST-BASED ECONOMY: A CASE STUDY OF JORDAN.

by

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Abstract

After more than a decade of remarkable growth, the contemporary Islamic banking movement, has reached a critical transition period. Criticisms, allegations and questions concerning the current practices of Islamic banks and financial institutions are becoming increasingly serious.

This thesis examines the viability of Islamic banks and financial institutions in an interest-based economy, which contradicts their ideals. It is concerned particularly with the experience of Islamic banking in Jordan. However, the assessment is carried out within the general framework of Islamic economic principles and precepts. Focussing on the implications of the hostile environment in which individual Islamic banks and financial institutions operate, the study provides an examination of the structure of the economic and financial system of Jordan.

The choice of Jordan as the area of study was made for several reasons. These include the fact that Islamic banking is well established in Jordan having started in 1979 with the Jordan Islamic Bank, which was classified the third largest Islamic bank in the world in 1987. This provides a proper field for study since it, to the author's knowledge, has not been tackled before. Another important fact is that Jordan has witnessed the first collapse of an Islamic financial institution in the world. The rise of the Islamic Investment House and the factors that led to its breakdown are a major concern of the study.

The findings of the research show that the Jordan Islamic Bank has proved viable compared to *riba* banks in Jordan. The results also show that the failure of the Islamic Investment House was mainly attributable to malpractices committed by its management.

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Declaration

I hereby declare that the whole of this thesis is the result of my own work and my indebtedness to other sources has been identified.

I also declare that no part of this work has previously or currently been submitted for any degree or qualifcation at this University or any other University.

Signed

Ramadan Abdullah Shallah

The Supervisor of this thesis was: Dr. Rodney Wilson,

Head of Department of Economics.

(O you who believe, fear Allah and give up whatever remains (due) from riba if you are indeed believers. But if you do (it) not, then be appraised of war from Allah and His Apostle ...)

The Holy Quran (2:278-9)

"Banking establishments are more dangerous than standing armies."

Thomas Jefferson (1743-1826).
U.S. Statement and President

Chapter I

Introduction

1.1 An Historical Perspective

Islam is presently passing through one of the most critical periods it has experienced throughout its history. Since the earliest days of its inception, Islam was conceived as an antidote to the world-wide darkness and chaos which had prevailed before its advent. There was not a single nation in that time that could be called healthy in temperament , not a single society that was imbued with high ethical ideals, nor a single state that was based on principles of justice, equity and fairness. There was a universal lack of wholesome leadership (Nadwi, 1973).

During these days, Islam liberated the soul of man from superstition and emancipated him from the evils of slavery. It saved human society from abasement and civilization from disintegration and ruin. When it had the opportunity, shaping life on just foundations, purifying belief and morality, Islam unified many societies across the barriers of race, language, culture and geographical location. When Muslims launched their holy wars in the glorious days of their history, they, in Watt's words,

> " not only had great military power but were culturally at a higher level. They also had an unshakeable conviction in the superiority of the Islamic religion" (Watt, 1983, p.3).

Medina, Baghdad, Andalus (Spain), Constantinople and other flourishing centres of the Islamic Civilization were the "minarets" which enlightened the path of humanity towards the roots of the present day scientific progress (see Khan, 1980).

These days of glory occurred when the Muslims apprehended Islam as a religion and a comprehensive code of life providing answers for the daily conduct of an individual or government or society. It was also a time when Muslims believed that the closer they were to their religion and faith the better it would be both for themselves and for the rest of the world.

Then came a time in which Islam lost its leadership due mainly to the failure of the Muslims to sustain and discharge sincerely and efficiently the great responsibility of the trusteeship of mankind which Islam had enjoined upon them and which had been associated with them at each turning point in history (Qutb, 1973).

The consequent inner weakness of the *Ummah* (the Muslim Community) allowed outside powers to march into the Islamic homeland in wave after wave of large-scale invasions throughout different periods of history.

The 19th and 20th centuries have witnessed the triumph of Western powers over the Muslim *Ummah.* What made this period significant however was the demise of the social order of Islam. It was in 1924 that the *Khilafa al Uthmaniyyah* (Ottoman Caliphate) was abolished and the first Muslim nation-state, the Republic of Turkey, came into being. In analysing such an event the author of *The Expansion of Islam*, W. Wilson Cash (1928) stated that:

> " The Islamic world reverberated to the earthquake that broke in pieces the pan Islamic league and placed nationality above religion" (p.2)

In fact, the restructuring of the geographical map and the fragmentation of the Islamic homeland which started during the Colonial period was merely an introduction to the reconstruction of the cultural and the civilizational identity of the *Ummah.* The rise of the Western style of the fragmented nation-states within the Muslim world has imposed formidable challenges on the *Ummah.* A new set of secular norms and Western-inspired cultural, political, and socio-economic development programmes were imposed as an alternative to the common civilizational heritage rooted in the consciousness of Muslims throughout their history. Thus, an unprecedented state of dependency of Muslims on Western thought and practice rapidly and widely made its appearance.

However, since the main focus of this study is Islamic banking, only the economic and financial aspect of this situation will be referred to here. In both the pre- and post-colonial periods, the idea which penetrated Westernized Muslim rulers and intellectuals was that the only way for the Muslim world to defeat backwardness and to achieve progress was to adopt the Western framework for socio-economic development. In other words, the Capitalist (and the later Socialist) economic paradigm with all its methods and instruments must unhesitatingly be implemented.

By far the most significant occurrence which has taken place in this domain is the introduction of *riba* banking to the Muslim world. *Riba* banking or interest-based banking is a Western development with its roots in medieval commercial practice. It was in fact a part of a secular rebellion against the medieval church which banned interest (usury) for Christians. Today, it represents the very life blood of modern capitalism.

Clearly, it seems, from the previous review, that *riba* banking was introduced to the Muslim world during the latter's state of decline, or in the words of Roger Cooper (1981, p.44),

> " at a time when the latter was in its lowest ebb"

Having traced the emergence of the earliest *riba* banks in the Muslim world Cooper also stated that:

> "The first European banks were established in Turkey, Egypt and Iran late in the 19th Century, often as a result of political pressures imposed on weak autocratic rulers and against the wishes of the Muslim population" (p.44).

The rise of *riba* banks in the Muslim world motivated a vehement controversy over the legitimacy and the permissibility of interest as well as other transactions performed by these banks. While such a controversy essentially absorbed the attention of Muslim scholars (the *Ulama*), it also stood as a critical test for Muslim masses to prove their loyalty to their religion. A great deal of evidence may be found in the story of the Savings fund (*Sunduq al Tawfir*), which was established in the early 20th Century in Egypt by the Egyptian Administration of Posts on a *riba* basis. Despite the low number of depositors at that time, over 3000 of them refused to take their due interest fixed by the Government (Mallat, 1988, p.29). More critical and important is the response of the *Ulama*. The advent of *riba* banking brought them face to face with their historical task of guarding the religion from corruptions or accretions and removing any related mystification amongst Muslims.

Despite all the efforts and sophisticated arguments made during many debates to legalize interest and to justify it on various bases, it was preponderatingly deemed by the *Ulama* to be *riba* which is prohibited in all forms as well as under all circumstances.

However, while for more than half a century the argument of the *Ulama* concentrated on stressing the prohibition of *riba* and the permissibility of profit via trade according to the *Quran*, no practical solution to the problem of Western banking was seriously developed. In other words, although the early debate over the subject has enriched Islam by highlighting and reconsidering its neglected economic and financial teachings and principles, it represented a negative (practically unproved) defence of Islam against hostile innovations and the encroachment of outside influences.

Meanwhile, the challenge of the *riba* banks has escalated so that by the late 1960's the finance of the Muslim world was entirely managed according to non-Islamic principles. For the time being, even if only the Arab *riba* banks are considered, they seem to constitute a gigantic empire of *riba* finance. In 1987, the total assets of the top 98* Arab *riba* based financial institutions, published in *The Banker* (Dec. 1988) amounted to US $276.72 billion. When Muslims live in a world where *riba* has become so ubiquitous, what kind of progress will they achieve if they are subject to "*a war from Allah and His Apostle*" (due to their involvement in *riba*), according to the *Quran* (2:279). What were the evil forces and influences which turned this great body of the *Ummah* from their age-old belief to the adoption of a practice so widely divergent from their religious instincts?

However, such a situation has never been seen as inescapable or unavoidable; eager to see Islamic finance stand on a realistic footing, Islamic scholars and economists introduced two modest experiments in the mid 20th century. The first attempt made to establish a *riba* free bank in the Muslim world was in Pakistan in

* Both the Kuwait Finance House and the Faisal Islamic Bank of Egypt are excluded from the list as being Islamic.

the late 1950s. (Wilson, 1983, p.75). More important however was the admirable experiment of the Mit Ghamr rural saving banks which started in Egypt in 1963. Unfortunately, (as long as secular politics holds sway), the inevitable end of such experimentation came when the Socialist Egyptian Government interfered and closed down the banks in 1968 (al Najjar, 1985). On the other hand, and in a different period of the Egyptian economy's history (i.e. during the *infitah* - the open door policy of the Sadat era), the Nasir Social Bank was set up in 1971, to serve Egypt's low-income groups on a *riba* free basis.

Notwithstanding these events, the development of the modern Islamic banking movement has only seriously started since the mid 1970s. The first remarkable step towards developing *riba* free banking in the Muslim World was the establishment of the Islamic Development Bank according to the recommendation of the Conference of the Finance Ministers of Muslim Countries held in Jeddah in 1973. As an international financial institution owned by the member governments of the organization of Islamic Conference (OIC), the bank started operation in 1975, as a governmental and development - oriented bank rather than a private commercial one. More crucial was the establishment of the privately owned Dubai Islamic Bank in 1975. This was the first initiative upon which the infrastructure of the *riba*-free banking movement was subsequently built. Such an initiative was followed by others, establishing several Islamic banks and financial institutions all over the world. Within a decade of its introduction, Islamic banking has achieved an impressive growth. From only one Islamic bank in 1975 the number of banks and financial institutions operating on a *riba*-free basis exceeded fifty in 1985. No contemporary financial system has made such spectacular strides as Islamic banking. In addition to the Sudan where Islamic banking is a remarkable feature of the financial system of the country, there are two other Muslim Countries - Iran and Pakistan which have already completely switched over their systems entirely to *riba*-free banking. In Saudi Arabia, the show place of Islam, there are no Islamic banks which can be identified as licensed deposit-takers except al-Rajhi Company for currency exchange and commerce, which has only recently been registered as a bank. Other groups such as Dar al-Mal al-Islami (DMI), and al-Baraka, operate as Investment Companies within the country.

Perhaps the most remarkable feature of the development of Islamic banking is its introduction to non-Muslim Countries such as the U.K., Switzerland, the Bahamas and even China. Similarly impressive is the action taken by a number of *riba* banks in both Muslim and non-Muslim countries; they have opened many "Islamic dealing" branches and divisions. It is hard for anyone to resist the temptation of expressing astonishment at this development. How very potent the influence of Islamic banking must be; nearly 20 financial institutions in Europe and the USA are currently using Islamic instruments to cater to the requirements of their Muslim clients. (Ali, 1988) Such a tendency, however, can easily be understood if one realizes that the City of London experts estimate that there is presently approximately £4 billion in the London financial market which could be seen as a potential target for Islamic banks (*Banking and Trade*, No. 1, Spring 1987). The depositors of these funds refuse to earn interest on them due to their religious and moral commitments. On the other hand, an indication of the British Government's attitude towards Islamic Banks can be given when Governor Robin Leigh-Pemberton of the Bank of England announced in October 1984 that no further banking licenses would be issued to Islamic banks. (See *Arab Banker*, Nov./Dec. 1984, p.3).

However, despite all restrictions presently imposed on Islamic financial institutions all over the world, it can be clearly shown that they have managed to make steady, and in certain cases, rapid progress, not only in terms of their number but also in the size of their assets.

Although it is difficult to trace all Islamic banks' records to pinpoint the size of their assets, estimates currently vary from US$ 20 to $ 40 billion (Syedain, 1989, p. 104). With such a huge financial muscle, Islamic banking has caught the imagination of Muslims and others alike. Islamic banking has been largely viewed as closely linked with the widespread contemporary Islamic revival. Many in the West however have viewed the Islamic revival with varying degrees of concern. The Islamic financial movement, as an important consequence and manifestation of this revival, has been considered as the most remarkable phenomenon in the Middle East financial world in recent years (Cooper, 1981). Over the last decade hundreds of conferences and symposia on Islamic finance as well as on different aspects of Islam have been held in the USA and in the West's universities and research centres. More exciting is that international institutions like the IMF have carried out a number of studies on Islamic finance, as the latter's implications stretch far beyond the Muslim world. To this extent, Islam has been 'rediscovered' by those modernisers, Western and Muslim alike, who earlier believed that it was becoming socially irrelevant (al-Mansour, 1983, p.50).

To sum up, it can be said that 'Islamic banking' in its early days was 'almost a joke'- a view commonly expressed by many observers. Today it has become a matter of reality. It has blown up the validity of the long-lived claim that it is impossible to imagine that a bank can be run successfully without interest in the modern world. It has, thus, vindicated the Islamic theory of finance proving its applicability in the sophisticated world of finance which exists nowadays. Moreover, it has helped a greater flow of literature on the subject through complementing more integrative and critical studies and discussions on the financial and economic theory of Islam. Research, and studies in Islamic economics carried out since the introduction of Islamic banking have surpassed all those done on the subject since the start of the present decline of Islam. In other words, Islamic banking has reflected the all-crucial move of Muslim scholars and economists from the negative and the theoretical defence of Islam to the positive, practical and proselytising demonstration of it.

1.2 The Motivating Problem

After more than a decade of its already demonstrated growth, Islamic banking has reached a critical transition period in its young life.

The beginning of the second decade of its experience has been marked with a new, but sceptical look at Islamic banks. As perhaps a victimized target, Islamic banking has come under fire astonishingly enough from both its early supporters and even more from its original opponents. Many criticisms of questionable credibility concerning the current practices of Islamic banks have been raised. Allegations of mistakes or even of malpractices are becoming increasingly serious nowadays. Some people say that Islamic banks are entirely profit-motivated institutions with no effort having been made to really benefit Muslim societies nor contribute to their development. Others say that they merely serve modern capitalism through speculating in the international financial markets or investing their funds outside Muslim countries. More aggressively and worse still is the claim that Islamic banks deal in nothing but *riba*; they are practicing the same acts as *riba* banks under the name of Islam. Regretfully, this means that doubts over the viability of Islamic banks have made their appearance again.

The Islamic banking movement appears to be in a critical situation as critics can without doubt point to the setbacks which have hit some individual Islamic financial institutions over the last few years. The following are the most prominent examples (see the *Annual Reports* of these institutions):-

- The Geneva based Dar al-Mal al-Islami (DAI), the mother company of some fifteen institutions, namely banks and investment companies, reported losses of U.S. $28 million in 1983 and U.S. $19 million in 1984 in investments in the international gold market.

- The Kuwait Finance House - the largest Islamic bank - which concentrated its investment portfolio on real estate projects was badly hit when the real estate market in Kuwait collapsed. The U.S. $93.7 million profits of 1984 where transferred to an emergency reserve fund; neither the shareholders nor the depositors received a return after a cash dividend of 20 per cent and investment deposit returns of 7.5 per cent in 1983.

- Islamic Bank International of Denmark (IBID) experienced substantial losses in 1985 and 1986 which amounted to more than 30 per cent of the paid-up capital.

- The most spectacular troubles were reported from the Islamic Investment House in Jordan which started operations in 1982 with the same paid-up capital as that of the Jordan Islamic Bank of JD4 million. The crisis of the House was so serious that it eventually led to its collapse, and hence its closure by the autumn of 1986.

Regretting all these occurrances, both the practitioners and the enthusiastic supporters of Islamic banking started to consider the negative impact of the indifferent environment in which Islamic financial institutions operate. It is the unhealthy environment that 'rocked the boat' said an Islamic banker; 'the hostile and unencouraging condition in which we operate', said another (see *Arabia*, Dec. 1985, p.55).

Thus, after more than a decade of experience, Islamic bankers began to realize that setting up an Islamic bank in an environment that is not completely Islamic is an immensely difficult if not impossible task (Abbas, 1985, p.67). That is to say, achieving such an ideal requires that the Islamization of banks should go hand in hand with an overall process of Islamization of society. However, as time goes by, the problems of Islamic banks will continue and the rumours will increase until such a process comes into being. Hence, in the absence of sufficient evidence which would determine the extent to which Islamic banks have lived up to their claims, the subject remains in an impenetrable fog.

Published reports and audited accounts cannot suffice to refute all accusations made against Islamic banks or to put doubts over their viability beyond all controversy. This undoubtedly proclaims the urgent need for action; an in-depth look at the present experience of Islamic banking in a largely indifferent environment is becoming indispensable. All criticisms must be objectively examined through empirical investigations with the goal of attaining a balanced judgement. Carrying out such an assessment will certainly serve to identify the problems facing Islamic banks and to suggest the corrective measures needed to reflate their positions. Such an action will also have its positive impact on the literature for the coming decade by contemplating the discussion which will help the promotion of economic and financial theory.

Accordingly, this study will attempt to explore the concepts of Islamic financial principles which relate to the implementation process of Islamic banking at the present time. So much, however, has been written on the theoretical side that it might be asked whether a further study can contribute to our understanding of the subject or not. Nevertheless, the case will certainly be different if the problems faced by Islamic banks in their daily operations are analysed within the conceptual framework of the Islamic financial and economic theory. Further, the case will be immensely different and perhaps the more exciting if a collapsed Islamic financial institution is investigated.

Thus, an empirical study based on the experience of Islamic banking in Jordan will be carried out as an essential part of this thesis. This naturally will raise the question of why Jordan? In other words, why is the Jordanian experience of special interest, one worth examining in particular. The answer to this question can be perceived through the following facts.

- Despite its small size, which implies the existence of a limited market, Jordan has one of the most developed and sophisticated banking systems in the Arab world. It includes commercial banks (both national and foreign), specialised credit institutions, financial intermediaries and many other financial entities as well as Islamic finance.

- The diversification of the operating financial institutions helped generate much competition in the financial sector. And this of course has had a considerable impact on the monetary policy of the country as well as its economic structure.

- Of special concern to the author, is the fact that the Jordanian economy is in some respects linked to the economy of the West Bank and the Gaza Strip, although there is no official connection between Jordan and Israel which has occupied these territories since 1967. Despite all restrictions imposed by the Israeli authorities, a large portion of remittances from Palestinians abroad, mainly the Gulf States, are transferred to the occupied territories across the Jordan River. In addition, many people in the West Bank and even in the Gaza Strip have their own accounts in Jordanian banks as well as involvement in business in Jordan.

- Islamic banking is well established in Jordan, with the Jordan Islamic Bank for Finance and Investment, which was the first Islamic bank to be established by a special law in 1978, and which started operations in September 1979. By the end of 1986 it was reported that the bank has ranked fourth amongst the 17 conventional banks (including the Housing Bank) in Jordan.

- During the first half of the eighties which witnessed the rise of Islamic banking in Jordan, the Jordanian economy was characterised by economic recession which started in 1983.

- More important is the fact that Jordan has witnessed the first collapse of an Islamic financial institution. This was the Islamic Investment House. An attempt to pinpoint the factors which led to its breakdown is urgently required.

- Contrary to those of Egypt, Sudan, Turkey and the Gulf States, the experience of Islamic banking in Jordan has not been the focus of empirical studies. To the knowledge of the author, the only work on this experience is Rodney Wilson's article which appeared in the *Arab Law Quarterly* (Vol. 2, No. 3, 1987).

1.3 The Hypotheses of the Study

In the light of the previous discussion of the problem under consideration, one major hypothesis as well as two other minor ones can be distinguished as follows:

- The major hypothesis:- The application of Islamic banking or any other aspect of Islamic economics in the unIslamic environment* prevailing in the Muslim world will not give the anticipated ideal results emphasised by the Islamic economic theory.

- The minor hypotheses:-

  - The success/failure of Islamic banking in a society is largely affected by the existence or non-existence of an Islamic monetary authority within this society.

  - The success/failure of Islamic banking in the contemporary Muslim world is highly dependent on the integrity, morality and the ability of the practitioners to enter the spirit of Islamic economics.

1.4 The Objectives of the Study

This study is dedicated to achieving the following objectives:-

- To explore the principles of Islamic banking within the general framework of the Islamic economic principles and precepts.

* See the definition of 'Islamic State' in Section 8 in this Chapter.

- To give a brief history of the Islamic banking movement and to shed some light on the different models of Islamic banking presently practiced at different levels in the world.
- To examine the implications of the environment in which individual Islamic banks operate through analysing the general structure of the Jordanian economy.
- To evaluate the overall performance of the Jordan Islamic Bank in order to test its viability or non-viability in comparison with *riba* banks in Jordan.
- To investigate the collapse of the Islamic Investment House in Jordan. The prime concern of this investigation will be revealing whether or not the failure was due to:-
  - The interest-free nature of the institution
  - Unfavourable factors stemming from the hostile economic conditions prevailing in the country.
  - Internal factors springing from the lack of integrity and management skills of the practitioners.
- To define an all-embracing conclusion and to formulate recommendations, in the light of the findings of the research.

1.5 The Methodology of the Study

The methodology adopted for this study is mainly divided into two aspects:

1) The theoretical aspect which involves two major steps:

i) Collecting material on Islamic economics in general and Islamic banking in particular from various sources including universities, banks, research centers, public and private libraries and the like.

ii) Using the available material to analyse the theoretical aspects of the working mechanism of Islamic banking at present.

2) The empirical aspect which involves the following:

i) Examining the main features of the Jordanian economy in general and the financial and banking sector in particular through:

- Referring to the available studies on the subject including books, dissertations, articles ... etc.

- Using the available public and private sources of statistical data including annual reports, monthly bulletins and many occasional publications.

- Conducting interviews with some senior directors of public institutions (e.g. The Central Bank) as well as many bankers and entrepreneurs.

ii) Analysing the banking operations and the investment activities of the Jordan Islamic Bank. This entails the evaluation of its performance within both the *shariah* framework and the financial and banking market in Jordan. For this purpose the following methods are adopted:

- Studying and analysing the *Annual Reports* and *Accounts* as well as other publications of the Bank.

- Examining the forms of all contracts and agreements conducted by the Bank.

- Conducting interviews with the senior management as well as some employees of the Bank, in addition to some of its customers.

- Applying the financial ratio analysis to the Bank's record and to those of all private *riba* banks in Jordan to identify its rank within the banking system.

iii) Investigating the collapse of the Islamic Investment house in Jordan through:

- Analysing the House's record prior to its failure depending on its published *Annual Reports* and *Accounts*.

- Conducting interviews with some of the employees of the House.

- Conducting interviews with the members of the temporary committee appointed by the Central Bank to monitor and follow up the affairs of the

House after its collapse.

- Interviewing some other parties involved in the matter including the previous General Manager's relatives, friends and supporters as well as many businessmen.

1.6 Scope and Limitation of the Study

The scope and the content of this study should be looked at in the light of the following:

- The scope of this study is different from other previous theses dealing with Islamic banking in other countries than Jordan. Three important factors will bring more difficulties and limitations into the picture:
  - Assessing the environment in which Islamic banking is operating through analysing the structure and the performance of the Jordanian economy.
  - Comparing the financial performance of the Jordan Islamic Bank with those of all *riba* banks in the country.
  - Investigating the first case of a collapsed Islamic financial institution (i.e. the Islamic Investment House).
- Due to the time constraints and the breadth of scope of the study, it was not possible to research in depth every aspect of Islamic banking, most of which have been dealt with in other studies.
- There is not a sufficient number of Islamic banks and financial institutions to carry out a comprehensive comparative study between such institutions within the same country. In addition to the Jordan Islamic bank, there was only the Islamic Investment House which had already met with failure. This was also the main factor behind the comparison between the recently established Islamic banks and the *riba* banks which have been established for a long time.
- Annual reports and financial statements of the institutions in question are an important source of information for the study. Thus, the research may suffer

from the limitations of these sources as defined in the literature, although they are taken with an awareness of their problematic nature.

- To overcome the above problem, vital additional information of great benefit to the analysis has been collected by the author. However, some critical details remain hidden by the managements of the institutions in question.

- What was really difficult, was the investigation of the Islamic Investment House. It was not an easy task to get the information that had been collected due to the secrecy and the confidentiality imposed upon the subject by the Jordanian authorities.

1.7 Some Relevent Concepts and Definitions

The purpose of this section is to highlight some basic concepts and definitions which are not central to the study but are still relevent. Essential economic and financial terms such as *riba* or *Mudaraba* will be dealt with in detail in the main body of the study. The materials presented here are selected from a variety of authoritative sources of different branches of Islamic Culture. Among these sources are al Salih, (1959); Ramadan, (1961); al Buti (1980); Mawdudi (1983); Khallaf (1977); Zidan (1982); Gauhar (1978); Faruqi (1986); Hunter (1988).

Allah: Although the word Allah is often translated as "God", there are some significant differences between the two words. According to Islamic belief, Allah is the creator, and sovereign ruler of the universe. Rejected by Muslims are the ideas that Allah could have sons or daughters, that Allah is limited in any sense and that humans could have the capability of understanding or being on the same plane of being with Allah. Because the word Allah is distinctive to the Islamic religion, this term will be used to refer to the idea of Deity. (However Allah is believed by Muslims to be the same God worshipped by Christians and Jews).

Amana: Fiduciary relationship; deposit on trust; trust.

Falah: Islamic term denoting success in both lifes.

Fatwa (pl. **fatawa**): Response on a point of Islamic *Shariah*, issued by a Muslim scholar or a *Faqih*.

Fiqh: *Fiqh* means literally "understanding, or comprehension". From the legislative viewpoint it refers to the science of Muslim Jurisprudence. *Fiqh* does not include matters of faith and morality (*alahkam al'itiqadiya wl-akhlaqiyyah*). It covers only the practical decrees (*alahkam al a'maliyyah*) which relate to human conduct (*mua'malat*) e.g., commerce, family law, international relations ... etc. and religious rituals (*Ibadat*) i.e. prayer, fasting, *Zakah* and pilgrimage. The science which provides the principles used to derive the decrees of *fiqh* is called (*usul al-fiqh*) (the roots of *fiqh*).

Fuqaha' (sing. **faqih**): jurists who give opinion on various issues in the light of the *Quran* and the *Sunnah* and who have thereby led to the development of *fiqh*. (Later: jurisprudents)

Halal: Refers to anything permitted by the *Shariah*

Haram: Refers to anything prohibited by the *Shariah*

Hijra: It refers to the migration of the prohet Muhammad from Makkah to Medina when the Quraish (the Arabic tribe of Makkah) plotted to assassinate him in 622 A.D. to bring an end to Islam. In the era of Umar ibn al-Khattab (the Second Caliph of the prophet) it was decided that the Islamic Calendar must be calculated with reference to the *Hijra* (i.e., 1989 A.D. would be 1409 A.H., after *Hijra*)

Ibadat: Adoration of Allah; rituals; religious activities.

Ijma': *Ijma'* is the third source of Islamic *Shariah* though its position is secondary when compared to the Quran and the *Sunnah*. In Juristic terminology it is defined as the consensus of the opinion of all Muslim Jurists on a particular question of *Shariah* within the limits warranted by the Quran and the *Sunnah*.

Ijtihad: *Ijtihad* is a particular type of academic research and intellectual effort within the legislative process which makes the legal system of Islam dynamic and makes possible its development and evolution in changing circumstances. Literally the word *Ijtihad* means 'to put in the maximum effort in performing a job', but technically it signifies maximum effort to deduct the decree of Islam in a given problem or issue for which no provision is found in the Quran or the *Sunnah*.

For undertaking *Ijtihad*, a jurist or a thinker must have specific qualifications in terms of faith, knowledge and personality. The practitioner of *Ijtihad* is called a *Mujtahid* (pl. *Mujtahidin*). The analogical reasoning of a *Mujtahid*, in any event, must be based on the *Quran* and the *Sunnah*. In the fourth century of the *Hijra* the "gate of *Ijtihad*" was officially closed, i.e. it was decided that it would not be allowed for any *Mujtahid* to undertake *Ijtihad*. However individuals (e.g. Ibn Taymiyya) continued to claim the right of *Ijtihad*.

The Islamic State: By *Islamic State* is meant the real Muslim state which serves obedience to *Allah* and submission to his orders through proclaiming and promulgating the *Shariah* as its fundamental law. In the present day Muslim Societies, the *Shariah* governs only personal matters without controlling the cultural and the socio political life of the *Ummah*. Thus none of the states within the Muslim world can be called an Islamic State* nor can the economy of any be called an Islamic economy. Hence, in this study the word *Muslim* will be used to refer to those unIslamic states i.e. "Muslim States" or *prima faice* Muslim which constitute the 'Muslim World'.

Islamic revival: The Islamic revival is the phenomena which resulted in the return to the Islamic life-styles and the fundamental precepts of Islam within the Muslim World today. The rise of the revival came in the early 1970s as a result of the gloomy conditions prevailing in the Muslim World. In the revivalist's view, the Muslim World is marked by internal degeneration, secularization, socio-economic injustice, political repression, and military defeat. Proponents and sympathezirs frequently use the expressions *al-ba'th al-Islami* (Islamic renaissance), *al-Sahwa al-Islamiyyah* (Islamic awakening) and *al-usuliyyah al-Islamiyyah* (Islamic fundamentalism). Nowadays the term fundamentalism is an essential part of the west's political, scholarly, and journalistic vocabulary. To the west, it also means radicalism. The revivalists are often misleadingly labelled as fundamentalists, radicals, extremists or fanatics. For a deeper understanding of the nature of the revivalist movement, Islamic banking, as presented in the study, must be understood as an integral part of this revival and one of its important manifestations.

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* The Islamic Republic of Iran is the only exception which proclaims the Shariah as its only and fundemental law.

Istikhlaf (vicegerency): The concept of *Istikhlaf* (vicegerency) indicates that Allah created Adam, representing the human being, to act as his vicegerent on earth. Many constructs of Islamic economic philosophy have been primarily drawn from this concept.

Jahiliyyah: It refers to the period in Arabia before the Advent of Islam. Translated it means 'ignorance'.

Madhhab (Pl. **Madhahib**): A *Madhhab* is a "school of *fiqh*" or "school of law". During the glorious age of Islamic juristic thought, numerous schools flourished but few have survived to this day. The most prominent of the *Sunni fiqh* schools number only four, called *almadhahib al arbaa'h* (The four schools):

i) The Hanafis. Named after Abu Hanifa al-Numan, (80-150 A.H. / 700-767 A.D.)

ii) The Malikis. Named after its founder Malik bin Anas, (93-179 A.H. 712-795 A.D.)

iii) The Shafiis. Named after Muhammad Ibn Idris Ash-Shafii (150-204 A.H. / 767-820 A.D.)

iv) The Hanbalis. Named after Ahmed Ibn Hanbal (164-241 A.H. / 780-850 A.D.).

Among the Shi'i schools of *fiqh*, the predominant is the Ja'fari *Madhab*, named after its founder Jafar al-Sadiq (d.148/765).

(Although the schools are named after their founders, strictly speaking it was their followers who founded the schools.)

Prophet Muhammad: Muhammad is Allah's Envoy (*Rasul* - a different concept than prophet, *Nabi*) to the Arabs and to mankind at large. He was born in 570 A.D. in Makka, received his mission in 610 and died in 632 in Medina. According to Islamic belief, Muhammad was a man and had no claims to divinity. He is special to Muslims because he is believed to have been the last of the prophets sent by Allah to guide man to the right path - the first having been Adam.

Nisab: A minimum amount of wealth, below which a Muslim is exempt from payment of *Zakah* in Islam. It works exactly like a poverty line.

Qiyas (analogy): *Qiyas* is a systematicized process of deduction by analogy relating to a *Shariah* question; it does not fall within the text of the *Quran*, the *Sunnah* or the *Ijma*, but does fall within their domain. i.e. which is not explicitly dealt with in the *Quran* or *Sunnah*, however these contain similar cases from which an analogy may be drawn.

Quran: The *Quran* is the original, primary, basic and most fundamental source of the Islamic *Shariah*. A fundamental belief of Islam is that the *Quran* is the last Book of Allah, which was revealed in its entirety as the infallible words of Allah. For Muslims, Muhammad was not the author of the words, but only the transmitter. This is important to remember when examining Islamic belief concerning interest (*Riba*). The *Quran* consists of 30 parts (*Ajza'*), 114 chapters (*Swar*, Singl. *Surah*) and 6,666 verses (*Ayat*, Singl. *Ayah*). There are a number of translations into various languages which are considered as merely giving a "meaning" of the *Quran* rather than being a literal text as in Arabic. In all references to the *Quran* in the text (e.g. 1:2) the first number refers to the *Surah* and the Second to the *ayah* or verse.

Shariah: It is the sacred law of Islam. It consists of the set of injunctions (*ahkam*), which Allah revealed to his servants whether through the *Quran* or the *Sunnah*. Muslim scholars (the *Ulama*) have distinguished three types of *Shariah* decrees:

i) Dogmatic decrees or those relating to belief (*ahkam I'tiqadiyyah*) and which are studied in the science of the unity of Allah (*al- tawhid*).

ii) Decrees relating to ethics, which are studied in ethics and mysticism (*al-akhlaq* and *al tasawwuf*).

iii) Practical decrees constituting the science of *fiqh* (see *Fiqh*).

Sihah (Singl. **Sahih**): The word (*Sihah* Pl.) refers to the most authoritative collections of the *Sunnah* called the six books "*al Kutub as-Sittah*". The collectors of the *Sihah* were al Bukhari (256/870), Muslim (251/865), Abu Da'ud (275/888), Ibn Majah (273/886), al Nasa'i (303/915) and al Tirmidhi (279/892). Among these, the first two stand apart, acknowledged by all Sunni Muslims in particular as more critical and authoritative than the rest.

Sources of Islamic Shariah: By sources of Islamic *Shariah* is meant the sources from which the proofs or evidence "*adillah shariyyah*", are obtained. There are a number of sources of Islamic *Shariah*. The *Quran* and the *Sunnah* are primary sources, whereas *ijma* and *qiyas* are secondary sources. While these four sources are acceptable to the four Sunni schools of *fiqh* (*al-madahib al-arbaah*), there are other secondary sources of *Shariah* which are controversial; a) *al-Istihsan* (juristic preference) b) *al-Istishab* (to take a decision on the basis of accompanying circumstances), c) *al-Masalih al mursalah* (Public interest), d) *al-'Urf* (Custom), e) *Ra'i al-Sahabi* (The opinion of any of the prophet's Companions), f) *Shar' manqablana* (the pre-Islamic legislation).

Sunnah: It is the second most important source of the Islamic *Shariah*. It refers to the prophet's sayings and deeds and those of his Companions said in his presence or he had knowledge of and which he did not disapprove of. It is closely related to the word *hadith* (Pl. *ahadith*) which means the narration of the life of the Prophet. The two words *Sunnah* and *hadith* are often used interchangeably. In this study, *hadith* will be used in order to refer to a particular saying of the prophet, while *Sunnah* will be used to refer to a pattern of life and thought which is based upon *hadith*.

Tawhid: *Tawhid* (the oneness or the unity of Allah) is the essence of Islam. It means belief in the one God with all his glorious names and attributes. Muslim scholars (the *Ulama*) distinguish between two concepts of *Tawhid*:

Tawhid al-rububiyyah: Based on this, Muslims believe that Allah is the Lord and the Sustainer, He is the creator of all things, He is the absolute regulator and controller of all things, He provides all sustainance and provision.

Tawhid al-uluhiyyah: This principle states that man has no right to worship any person or thing except Allah. Therefore the Muslim should reject all sources and symbols of authority and power in favour of the supreme authority of Allah, which provides man with the ideal approach in all spheres of life, be they economic, political, social, ... etc.

Zulm: A comprehensive term used to refer to all forms of inequity, injustice, exploitation, oppression and wrongdoing, whereby a person either deprives others of their rights or does not fulfil his obligations towards them.

1.8 Format of the Study

This thesis is divided into ten chapters. The first chapter is an introduction to the study . It provides a background to the problem and explains the purpose and methodology of the study. The second chapter is a broad introduction to Islamic economics . It highlights many important issues which indicate that Islamic banking is an integral part of Islamic economics and hence the comprehensive Islamic system of life.

Moving from the general to the specific, the theory of *riba* is discussed in the third chapter. Addressing the Islamic solution to the problem of *riba*, the theoretical and practical development of Islamic banking is examined in the fourth chapter. The field study work of the thesis begins in Chapter 5. Having proceeded to this, the fifth chapter reviews the features and performance of the Jordanian economy. The interest-based financial and banking system of Jordan is examined in the sixth chapter.

The remainder of the thesis is the backbone of the study where a careful appraisal of Islamic banking in Jordan is made. The seventh chapter covers the origins and development of the Jordan Islamic Bank. An evaluation of the performance of the Jordan Islamic Bank is carried out in the eighth chapter. the ninth chapter tackles the rise and collapse of the Islamic Investment House. The last chapter of the thesis includes the conclusions and recommendations of the study. The thesis ends with relevent appendices and the bibliography.

Chapter II

Islamic Economics : An Overview

2.1 Introduction

Islamic banking is a crucial manifestation of an historical process of transition in the contemporary Muslim World for developing a new ethically-based discipline, namely Islamic economics. This chapter is essentially designed to shed some light on some important aspects of this discipline. For this purpose, this chapter is divided into four major sections following this introduction.

The first section provides a conceptual framework for the study of Islamic economics with an emphasis on its nature, meaning and development, while the second section is concerned with the main characteristics of Islamic economics. Its objectives as they can be envisaged in contemporary world are discussed in section three. Finally, the crucial idea that Islamic economics is an integral part of the comprehensive system of Islam is indicated in section four.

2.2 A Conceptual Framework for The Study of Islamic Economics

2.2.1 What is an Islamic Economy ?

Given the topic of this thesis which is concerned with Islamic banking in an unislamic (an interest-based) economy, the first issue which must be dealt with is to answer the question: "What is an Islamic Economy?"

At the outset, it must be clear that Islam as a comprehensive way of life has its own broad and flexible economic principles which permit Muslims to construct their ideal economy irrespective of time and place (Siddiqi, 1970).

Thus Islamic economy can be referred to as the operating economic system which is primarily based on the economic teachings and principles of Islam.

Past experiences of the Muslim *Ummah* suggest that Islam was always able to provide suitable solutions for problems facing Muslims in the areas of trade, agriculure, and all traditional economic activities. These experiences in Islamic history have clearly proven that religious beliefs can largely be incorporated into economic activities.

Unfortunately for Muslims, however, Islamic economic principles were relegated to the shelves of libraries and forgotten manuscripts. Most forgot that a comprehensive and well-established Islamic economic system had existed at one point in time.

Since the early thirties of this century, however, an ever-increasing amount of attention has been focussed on the subject. A brief history summing up the evolution of Islamic economic thought through its different phases will therefore be provided.

2.2.2 The Evolution of Islamic Economic Thought

Many attempts have been made in this domain to focus on significant turning points in the history of the Muslim *Ummah.* Al Fanjari's work (1981) is perhaps the first and the most appropriate one to begin with.

According to al Fanjari, there are three major periods which can be distinguished in the evolution of Islamic economic thought:

1. The period of prosperity:- This started from the beginning of the Islamic mission to the end of the fourth century of the *Hijra.*

Within this era two types of Islamic economic studies can be distinguished:

i) Dependent studies, which refer to the economic question as an integrated part of the Islamic jurisprudence (*Fiqh*) rather than a separate distinctive discipline.

ii) Independent studies, which refer to a detailed and advanced treatment of economic issues in Islam. The most common and distinctive contribution in this field was Abu Yusuf's work (113-182 A.H. /731-798 A.D.) known as *Kitab al Kharaj.*

2. The period of stagnation:- According to al Fanjari this period started with the closing of the "*gate of ijtihad*" at the end of the fourth century of the *Hijra*.

However, the theory that the closing of the "*gate of Ijtihad*" is the turning point from which the period of stagnation started is not without contention as there are some exceptions to this division; a) before the closing of the "*gate of Ijtihad*" many incidents and events took place, which affected the strength of the process of *Ijtihad*; b) many cases of *Ijtihad* are to be found after the official ban on it i.e., many of the pioneers of the early *Ulama* made their appearance after that date. Some examples are; Abu Hamid al Ghazali, the author of *Ihya' Ulum al Din* (Revival of Religious Sciences) (451-505 A.H. / 1055-1111 A.D.), Ibn tayimiyyah (661-728 A.H. / 1263-1328 A.D.), his disciple Ibn al Qayyim (691-751 A.H. / 1292-1350 A.D.) and Ibn Khaldun (732-808 A.H. / 1332-1404 A.D.).

More convenient in analysing the period of stagnation was the attempt made by El-Ashker (1987) to demonstrate the factors accounting for the decay of the Muslim *Ummah*. A summary of these factors can bring them into two main categories; internal and external factors. While the former are related to the belief of the *Ummah* and its adherence to Islam, the latter refers to the exogenous threat and invasion of the Muslim World.

No matter what the implications of the above factors were, they undoubtedly left their negative impact on the evolution of Islamic thought. Hence, despite the patently significant and undeniable contribution made by many *Ulama** during this period, Islamic economic thought generally experienced a phase of stagnation.

3. The period of resurgence:- This is an important facet of the contemporary Islamic revival which covers so many aspects of Muslim life in the present day.

Apart from the simple division provided by al Fanjari, it can be said that most of the stimulus for Islamic economics has been provided by the challenges

* Of the outstanding studies which covers the history of Islamic economic thought are; Ahmad's (1969), namely, "The origin of economics and the Muslims"; Siddiqi's (1982) namely, "Recent works on history of economic thought in Islam" and Mirakhor's (1987), namely, "The Muslim scholars and the history of economics".

of contemporary Western economic thought to the Muslim countries. Since the early 20th Century the Muslims have, however, blindly following the West in everything. They have, therefore, imported almost all the sources of the socio-economic problems which the world economy has been experiencing. The West has historically and frequently experienced serious crises. The great depression in 1929 was the event which overshadowed the years between the two world wars. The crises were further aggravated; the extreme poverty and even the threat of hunger to more than half of the world population. In addition the rapidly increasing disparity between the rich and the poor countries became a prominent feature of the world economy (Hoffmann, 1971). Deeper and more serious is the present world-wide economic crisis. Various forms of socio-economic injustice are now the norms. The international financial and monetary system is out of balance*. Inflation and unemployment are rampant in many countries. Chronic balance of payment deficits seem unavoidable. The gravity of these and other problems has been perceived to be so serious that it has been said that:

> "No previous theory seems capable of explaining the current crisis of the world economy" (Kissinger. 1983, p.16).

Since the above problems have been a fact of life for the Muslim countries ever since their so called independence from the colonial powers, Muslim thinkers began to search for a new approach which could address itself to such a serious situation. The inevitable, and indeed the natural choice for them, was therefore the reexamining of their own position from the ideological benchmark of Islam .

Hence, over the past half-century Muslim thinkers have come forward with numerous proposals to voice the Islamic approach to the major economic problems and challenges that were encountered by the *Ummah.*

In the early phases of the contemporary resurgence of Islamic economic thought the emphasis was laid upon demonstrating the fundamental economic teachings of Islam. This was also associated with establishing an Islamic critique of the contemporary Western economic theories and practices. Most of this work was done by the *Ulama* and Islamic intellectuals as well as Muslim reformists (of special interest in this respect were the pioneering tracts of Abu al A'la al

* The very recent crash of the international financial market in October 1987 is evidence of this

Mawdudi, Sayyid Qutb and Muhammad Baqir al Sadr, which are still in print and widely read).

Steadily, a new generation of Islamic economists, who were mostly the outcome of the modern Islamic movement, became involved in this challenging intellectual and civilizational endeavour; "Islamic economics" has become an arguable issue for the first time in history.

Notably, spectacular progress towards reconstructing the economic thinking of Muslims has been made over the last decade.

Greater interest in Islamic economics has been widely reflected in:-

- The increasing outflow of literature on the subject
- The increasing number of international conferences and seminars held in different aspects of Islamic economics.
- The emergence of some international and local institutes and research centres to organize teaching and research in Islamic economics.
- The move towards teaching Islamic economics; more than two dozen universities of the Muslim World are presently engaged in teaching specialised courses in the subject.
- The emergence of many specialist periodicals covering different aspects of Islamic economics.
- The application of Islamic economics on different levels as the Islamic economic system has been seen by both governments and individuals as the only way for alleviating poverty and achieving justice and progress as will be explained later.
- The attention paid to the subject by non-Muslim economists and policy-makers who have been concerned with the subject during the last decade.

However, the above accomplishments and the citation of the term "Islamic economics" at this point stimulate some important but age-old questions; does

Islamic economics exist ? If so, what does it consist of ? And what makes it distinctive ?

Such questions are indeed difficult to answer especially due to the limitations set by the scope of this study.

Nevertheless, since the success/failure of Islamic banking hinges crucially upon the existence/non existence of various vital factors within Islamic economics, it is essential to attempt to answer such questions without indulging in unnecessary attachments. This is necessary both for clarity of thought and the subsequent exposition of ideological aspects of Islamic banking.

2.2.3 Does Islamic Economics Exist?

To cut a long story short, it may be useful to begin with a relevant statement of a leading contemporary Islamic economist. In an early assessment of the contemporary Islamic economic thought, Professor Khurshid Ahmad (1981, p.11) stated that:

> " we are passing through a period of creative transition, moving from a simple expose on 'Economic Teachings of Islam' to an articulation of what can be technically described as 'Islamic Economics'"

Another corroboration was demonstrated by Volker Nienhaus (1985) who stated that:

> "The Muslim World saw in the last decade the emergence of a new discipline; Islamic economics". (p.16)

Although the above notions of such scholars seem to be satisfactorily in accordance with the view that Islamic economics does exist, it is more convenient to investigate briefly the phases of development of the subject during the contemporary period of resurgence.

Events and academic efforts provide the basis for distinguishing various stages through which Islamic economic studies have passed during this resurgence. However, in this abridgement, two major phases are to be distinguished, separated by a critical turning point.

Generally speaking, by the beginning of the second half of 1970s the Muslim World saw some of the most critical events in the history of contemporary Islamic economic thought. As far as the application of Islamic economics, or any of its aspects, is concerned, the mid-1970s witnessed the establishment of both the Islamic Development Bank and the Dubai Islamic Bank, making Islamic economics a reality.

Intellectually, the first international conference of Islamic economics was held in Makkah in February 1976. Given such unprecedented developments, it seems reasonable to assert that the mid-seventies can be claimed as a major turning point in the evolution of contemporary Islamic economic thought.

Accordingly, studies which contributed to the promotion of the subject during the period of resurgence can generally be looked at under two major categories:-

1. Studies before mid-1970s

Economic studies during this period either concentrated on general economic principles in Islam or focused on one or more separate aspects of Islamic economic thought such as *riba, Zakah*, property ownership ... etc. In addition, limited studies have also been made concerning the contribution made by early Muslim scholars to economic thought.

Despite the notable literature which has been produced including the presentation of some exceptional works it can generally be said that most of the studies developed during this period have been characterized by some specific problems and difficulties which are principally as follows:

- The focus of the literature was merely the rediscovering of the fundamental teachings of Islam rather than developing a methodology of economic theorizing i.e. "Islamic economics" had not been yet developed.
- There was a clear confusion over the concept of many economic issues which resulted from the problem of terminology. No rigid distinctions were drawn between many terms. The terms: theory, doctrine and system were, for example, used interchangeably.

- The confusion between Islamic economics and public finance in Islam, for instance resulted in many presentations being entitled "Islamic economics" although in fact they only dealt with *Zakah* or taxation in Islam.

- An overstressing of, and concentration on partial (separate) economic or financial studies; a large number of presentations have focused on *Zakah, riba* or insurance as if they were the only aspects of Islamic economics.

- Many studies, mainly those prepared by the leftists, have been titled so that they seem to present the Islamic stance in economics when in reality their sole intention is to discredit Islamic economics.

- Some of these studies have been distorted by alien opinions introduced into Islamic economic thought to justify the non-Islamic economic models and practices which have dominated Muslim Countries in the last few decades.

- The gulf between the *Ulama* and the economists that has existed for a considerable time has stifled advances in this field. Most of the literature of this period appear to be written by those who do not have serious training in economics. Today all those interested in the subject realize that without synthesis of these two bodies of knowledge (the religious and the economic) no progress in Islamic economic thought can be achieved.

- The literature of this period appears quite repetitive and new ideas are often quite rare. i.e. a great variety of studies have been produced under the same headings with almost the same contents.

- Many of these studies have been seen as sentimentally-oriented rather than systematic or analytical in approach. This of course was a result of their aim to defend Islam against challenging imported ideas as mentioned in the introductory chapter of this thesis.

However, the clear implication of all the above is that a great deal of literature was steadily emerging out of its long absence to assume its position as the milestone of the intellectual production of the second period of this review.

2. Studies after mid-1970s

This period represented quite a significant jump in the history of contemporary Islamic economic thought.

A great deal has been written on the subject by both Muslim and non-Muslim economists; much of it has attempted to overcome many of the shortcomings of the previous period. Of particular significance is that these studies have also attempted to bring together both theory and practice in Islamic economics.

However, despite all the achievements and progress made by these studies, they are still suffering from some unfavourable features:-

- Despite all valuable attempts made towards building up an infrastructure for a new discipline, namely '*Islamic Economics*', there was no agreement amongst Islamic economists as to a clear concept of its nature and scope. The confusion of the pre-mid-1970s period over such issue has not been alleviated; the controversy over whether '*Islamic Economics*' is a doctrine or a science, a system or a theory, normative or positive ... etc., is still going on.

- There was an overstressing of Islamic banking as if it was the only aspect of Islamic economics. Perhaps this tendency was an essential response to many questions related to the application of Islamic banking since it was very recent and faced many practical problems which needed to be solved. However, what may be criticized here is that most of the studies implemented have dealt with Islamic banking as a separate subject which has its own problems and implications unrelated to those of Islamic economics as a whole. Only in the last few years have Muslim economists started to pay attention to such issues by regarding Islamic banking as an integral part of a comprehensive and coherent system namely Islamic economics. With vital importance in this field is the distinctive and pioneering work of Chapra (1985), *Towards a just monetary system.*

- Similar to those of the previous period, most of the studies carried out during this period were relatively repetitious; only few can be looked at as innovating and distinctive pieces of work. In other words, there was a great success in terms of quantity but only a modest contribution in terms of quality.

- Relatively, there was also an increasing tendency towards the mathematization of economic principles. i.e. the overdependency on mathematics in economic research. Although, mathematics is widely recognized as an important tool for researching in economics, the overemphasis on its use in Islamic economics at such an early stage of development can be questioned:

  - Part of the reason of this tendency can be understood as a reaction to those who grudgingly suggest that Islam has only a few old-fashioned economic teachings which cannot be applied in modern age.

  - Since Islamic economics is still passing through its early stages of development, it is very dangerous to deal with its conceptualization as a branch of applied mathematics. Many issues from the ideological standpoints still need to be discussed and identified, mainly in relation to the islamization of a whole economy in the very sophesticated contemporary world.

  - If Islamic economists choose to imitate the approach adopted by western economists, two important facts must be noted. Firstly, when the latter developed their mathematical economic models they already were in possession of substantial and conceptually clear economic theories; of course, this is not the case with Islamic economics nowadays. Secondly there is the fact that the approaches taken by western economists are widely criticized by both Islamic and non-Islamic economists. e.g. see Buchanan (1979) and, Sakr (1981).

On the whole, despite all of the above, it can be said that efforts made by Islamic economists over the last decade have, without doubt, contributed to the development of a systematic approach to the study of Islamic economics which is currently emerging as a distinct academic discipline (Mannan, 1986).

In conclusion, it is important to answer the second previously mentioned question:-

2.2.4 What is Islamic Economics ?

Perhaps this is the most difficult and controversial question to answer. Islamic economists have widely discussed the meaning and the nature of Islamic economics without arriving at an agreement on any single definition of this discipline. Among those who contributed to this issue are al-Sadr (1981); al-Arabi (1966); Abdou (1974); Abu Saud (1980); Sakr (1978); Siddiqi (1970); Ahmad, K. (1976); Zarqa (1980); Kahaf (1979); al-Fanjari (1981); Mannan (1986); Khan (1984); Hasanuz Zaman (1984) Ariff (1985a) and others.

Many of the definitions suggested by some of the above mentioned scholars and others were expressed in the context of and in relation to the modern concept of economics, be it in terms of scarcity or material welfare. Although Islamic economists did their best to accommodate and qualify the definitions of economics with Islam, such a trend remains questionable and may have negative implications for the development of Islamic economics as an autonomous discipline with its own distinctive features. However, while the author does not intend to digress in discussing such implications or examining any of the suggested definitions in the literature, it is important to have a clear vision of what is meant by Islamic economics in this study.

For this purpose, a definition which may simply express the core of meaning as is understood from the literature, is to be made as follows:

> "Islamic economics aims at the study of how man uses resources for the realization of *falah*"

By *falah* it is meant the success of man in satisfying his worldly needs, which enables him to perform his duties to Allah and society as the means of his salvation in the hereafter.

However, bearing in mind the problem of terminology in the literature which was mentioned earlier, the term 'Islamic economics' in this study is generally used to comprise all terms used interchangeably in the literature. It is simply referred to as general economic fundamentals deduced from the *Quran*, the *Sunnah*, and the *ijtihad* of Muslim scholars established in different environments and age in accordance with these sources.

Last, but not least, is the forementioned question, what makes Islamic economics distinctive? By nature, the answer can be found in its distinctive philosophy, features and objectives as well as other aspects which will be treated in detail in the following sections.

2.3 The Main Characteristics of Islamic Economics

2.3.1 An *Aqida*-Based* Economics

Whatever aspect of Islamic ideology one wishes to study, one must, first of all go to the roots and investigate the fundamental principles. This will provide a satisfactory understanding of the ideology and its specific injunction as well as its spirit and nature. The economic philosophy of Islam overshadows every other question related to economic action. It affects the economic system in various ways. It influences both the ends and means of the system; what its goals are, including the priorities among them; the institutions and instruments of the system and the pattern of their uses; and attitudes about changes in goals (short-run), policies and instruments.

The key to the economic philosophy of Islam lies in man's relationship with Allah, other human beings, and the universe, i.e. the nature and the purpose of man's life on earth. (Siddiqi, 1981).

The Man-Allah relationship is defined by *al Tawhid* (both *Tawhid alrububiyyah* and *Tawhid al-uluhiyah* as defined earlier). The essence of *Tawhid* is a total commitment to the will of Allah involving two important concepts:

i) *al-Istikhlaf* or the vicegerency which gives man the role of being the agent of Allah in this world [The *Quran*; (2:30), (6:165), (27:62), (35:39), (57:7)] and,

ii) the brotherhood and equality which defines the relationship between man and man in life.

Many constructs of Islamic economic philosophy have been drawn from the concepts mentioned above. The following are examples of these constructs.

- The purpose of man on earth is to build the kingdom of the Lord according to His will and guidance. Thus, the entire universe with all its natural resources

* The words 'ideological' or 'dogmatic' do not satisfy the exact meaning; aqida-based means based on the article of faith

and powers is made available to man in order to achieve this purpose [The *Quran*; (67:15), (22:65) (45: 12-13), (31:20)]

- Allah has bestowed blessings on the earth and resources are given in abundance. The *Quran* says:

  "And He (Allah) gives you of all that you ask for; and if you count Allah's favours, never you will be able to number them. Verily man is given up to injustice and ingratitude" (14:34)

  Hence, scarcity is caused by human limitation (see: al-Sadr (1981), Abdou (1974); and Abdul Rauf (1979)).

- Man, being an agent (*Khalifa*) has to develop greater knowledge and skills and should endeavour to explore, to discover and to exploit the resources for his own interest, but not as a free agent. In his exploitation of resources, he must use methods and means within the framework of the *Shariah* (the law) given to him.

- Allah is well acquainted with his creators and provides for them according to His just measures. (67:14), (23:18), (42:27), (43:11).

- All things which have been given to man reside in Allah's trust and therefore, man is responsible and accountable to Allah. In the day of judgement he shall be asked for every form of joy which Allah has bestowed upon him during his life. "*Then, shall you be questioned that day about the joy (you indulged in!)*" (102:8).

- Allah is the provider of man's wealth and He is the original and the real owner. Man's temporal possession is limited and is granted by Allah; man is merely a "*trustee*" for a term. Realization of his dual ownership mitigates against selfishness, greed, and dishonesty which often results from the deceitful notion of absolute ownership.

- Wealth is to be regarded as a means and not a final aim. It is a means of satisfying needs, of providing sustenance in moderation, for the survival of a limited term of life on earth, leading to a more meaningful and lasting life hereafter, e.g. "*He who has created death and life that He may try you -*

which of you is the best in deeds; and He is the Mighty, the Forgiving" (67:2). This means that the reward of the hereafter must enter the profit and loss calculations in Islamic economics. This also will give a new interpretation to the idea of profit and loss. The latter can be regarded as profit when it is incurred for the sake of Allah and the former can be regarded as loss when it is gained in violation of the principles of Islam.

- All human beings are created equal; each man is brother to another man (7:35) and no one may claim inherent merit over another. However they are created with different talents and capabilities and are bound to attain different degrees of success. As a human being, man has to accept his fortune, not to despair nor to be resentful, although he has to struggle as hard as he can for his best interest according to the dictates and conditions of his creator.

In addition to the ideological concepts that may appear from the characteristics of Islamic economics (outlined in the following section) the forementioned concepts have formed an umbrella for the economic system of Islam together with its structure and content, i.e. the laws of ownership, production, distribution ... etc.

2.3.2 The Flexibility of Islamic Economics

The question of whether the Islamic economic principles of the seventh century are applicable in the sophisticated world of today or not, is one of the most impotant issues to be investigated. Timur Kuran (1986), one of the most aggressive opponents of Islamic economics in the present day has grudgingly stated that it is a

> "... mistaken belief that the Islamic norms could play a central role in a modern society." (p.142)

To refute such a claim, it is necessary to address the vital issue concerning the contradiction between the constancy of the Islamic *Shariah* and the dynamism of life. Islamic *Shariah* recognises this matter more than anything else and consequently expresses itself in the form of general principles and rules from which the social images of societies can grow within the general framework. Thereafter these images should only differ from each other in relation to the minor issues and technical forms (Qutb, 1983). Without any contradiction being made with the fixed objectives of Islamic *Shariah*, this characteristic is defined as the flexibility of Islamic legislation. In the centre of such a notion is the concept of *Ijtihad*. The process of *Ijtihad* in the Islamic approach is the vital instrument which maintains the flexibility of Islamic economics. Consequently, various facets of Islamic economic systems (e.g. the industrial, agricultural, commercial etc.) can be produced not only because of an increase in needs or changing circumstances, but also because of the processes of *Ijtihad* and the various methods of deducing judgement from the text.

For more understanding of the matter it can be said that the flexibility of Islamic economics is reflected in its content, which is comprised of two facets. (al Fanjari, 1981)

Firstly, the permanent face, which concerns the Islamic economic principles and fundamentals set down in the *Quran* and the *Sunnah*. Muslims should follow them at all times and in all places regardless of the level of economic development or pattern of production etc. of that society. Among these principles and fundamentals are: the prohibition of riba, the right of qualified private ownership, and the obligation of *Zakah* (the religious tax on wealth) as an important instrument of income distribution.

Secondly, the dynamic face which relates to the application of Islamic economics. This must be based on the permanent principles which indicate how Muslims can deal with the economic problems of their time and provide solutions. The performance of this duty by Islamic economists and the *Ulama* was laid down in a framework described by Baker al Sadr (1981) as "the area of vacancy in Islamic legislation". It is the responsibility of the Islamic authority to fill this vacuum with suitable judgements and injunctions. This must include methods and practical plans that provide Islamic solutions to many economic problems e.g. formulating measures to achieve a fair distribution of income or to achieve increases in production.

On the whole, flexibility is the crucial means which guarantee the applicability of Islamic economics in all times and all places. However, it must be noted that this flexibility must not be perceived as a justification for corruption in the economy. It does not pander to the wishes of society - if it did, this would lead to the weakening, perhaps even the destruction of its values.

As far as the applicability of Islamic economics in the contemporary world is concerned, Islamic banking which is the main focus of the study is an obvious example.

2.3.3 Morality of Islamic Economics

One of the most distinctive features of Islam is the stress it lays on ethical and morally responsible behaviour in all spheres of human activity. This was emphasised by the Prophet Mohammad who asserted that the core of his mission was to honour the code of noble manners and behaviour.

The Muslim's moral obligation is to be a pure example of honesty and perfection, to fulfill his commitments and perform his tasks well, seek knowledge and virtue by all possible means, correct his mistakes, and repent his sins, develop a good sence of social consciousness and nourish a feeling of human response, provide for his dependents generously but without extravagance and to meet their legitimate needs (Abdalati, 1975). The moral principles of Islam are expressed in both positive and negative committments. While positive commitments refer to duties which must be fulfilled (*Wajeb* - which can be simply understood as *halal*) e.g. paying *Zakah*, the negative indicates things which must be avoided (*haram*) e.g., dealing in interest (*riba*). This means that the principle of *halal* and *haram* in Islam constitutes the fundamental grounds of morality in Islam. Given the implications of this principle it appears that it is designed to build-up a healthy and prosperous society.

The range of morality in Islamic economics is so inclusive and integrative that it combines all aspects of economic activity.

Islam decrees that rightiousness should place economic activity on a moral foundation. Hence, just as Islam exhorts people to be truthful and honest, and restrains them from forgery and creating discord, similarly it exhorts them to help the poor and restrains them from doing injustice, from encroachment upon the rights of the others and from collecting money through unlawful means. All business deals should be concluded with frankness and honesty. Cheating, hiding the defects of merchandise from buyers, exploiting the needs of customers, monopolization of stocks to force one's own prices are all sinful acts and punishable by Islamic *Shariah.* It is narrated that:

> "one day the Prophet was going to prayer and he saw people buying and selling. He called to the merchants and traders so that they looked up. The Prophet told them: '*Traders will be resurrected on the Day of judgement as sinners, except those who are honest and righteous.*' And the Prophet continued: '*The honest businessman will be resurrected on the day of judgement among the Prophets, the most truthful and the martyrs.*'" *(al Tirmidhi)*

This high-level of morality is undoubtedly the crucial factor which guarantees the successful functioning of an Islamic economy on the one hand and assures its distinctiveness amongst any other economy. Although capitalist economist are showing signes of becoming increasingly aware of the role of ethics and morality in economics, an exclusive emphasis on profit-making and self-interested motivations are still the norm and the salient feature of capitalist economies.

Modifications introduced to these economies by socialist reformers, although aimed at moderating the excessive abuses of capitalism, have proven a failure: they were essentially tinkerings to modify details of the system and did not address themselves to fundamental changes. James M. Buchanan, an American Nobel prize winner for economics in 1986 has stressed this fact in his article* *Methods and Morals in Economics* saying that:

> "But political attempts at correcting market breakdown also founder on the rocks of measurable economic self-interest of the participants. No person is motivated to undertake the costs of organization that may be required to generate the public goods that corrective reform represent. Elected and appointed politicians and bureaucrats are not different from other men. They are motivated at least in part by their own interest, not by some higher version of the 'social good'." (1979, p.211)

He further pointed out that:

> "Maintenance of a viable social order characterized by substantial individual liberty depends critically on the widespread acceptance of a common set of moral precepts. Such acceptance is by no means assured in our word of the 1970s." (p.213)

* This article was initially published in 1976, but reprinted as a chapter of the author's book "What Should Economics Do ?" published in 1979.

2.3.4 Realism of Islamic Economics

The realism of Islamic economics is by definition rooted within the realism of Islam as a religion whose ultimate aim is the general welfare of man according to the possibilities within his reach. Islam accepts man for what he is and exhorts him to become what he can be. Thus, Islamic economics do not indulge in wishful but unpracticable thinking. Nor does it demand the impossible or float on streams of unrealistic assumptions as is the case with the manmade modern economic doctrines.

According to Jones (1979):

> "A common complaint of economic theory in general (and economic growth in particular) is that it is unrealistic and by implications useless" (pp. 6-7)

Attempting to mitigate the gloominess of the picture he added:

> "It is simply naive to argue that an economic theory is 'unrealistic' per se; it may be reasonable to argue that the assumptions are too unrealistic"*

However, this may accelerate the criticisms - what does the realism of an economic theory per se mean since the underlying assumptions or postulates are questionable or too unrealistic?

By nature, this is no longer the case with Islam. One relevant example is the difference between the concept of the rationality of the economic man (*homo economicus*) developed by modern economics and the concept of the rationality of the Islamic man (*homo Islamicus*) developed by Islamic economists, which will be clarified later.

For the clarity of picture, it must be understood that the realism of Islamic economics is demonstrated through its aims as well as the methods through which these aims can be achieved. The objectives of Islamic economics are to be established according to the capability of the human being. This relates to the fact that Islamic legislation is based on a profound understanding of the nature of the human beings. For example, Islam gave man the right of private ownership since it is beyond all doubt that private ownership is an expression of a natural

* An argument along these lines is closely associated with Friedman's famous essay on methodology (1953). See also Koopmans (1957) Essay 2.

instinct. Another example for the uncomparable realism of Islamic economics can be found in the most distorted precept of Islamic legislation, namely the "amputation of a thief's hand". It is true that Islam prescribes that a thief's hand, should be cut off, but it must be noted that such a punishment should never be inflicted where there is the slightest doubt that the thief was driven to crime by hunger or pressing need. A tradition of the prophet relates how one of his companions was robbed of his cloak while praying in the mosque. He caught the thief who committed the crime and took him to the prophet, but when the prophet ordered his hand to be amputated the companion became most distressed, realizing that the man was needy. He immediately gave the man his cloak as a charity. The prophet asked: "*Why did not you do that before bringing him here ?*" (al-Nawawi's Forty Hadith). Another important but very well-known example is the decision taken by Umar Ibn al Khattab, the Second Caliph of the prophet, when he adjudicated that no thief's hand should be cut off during the year of famine. (see Sayyid Sabiq, 1973)

It is clear that the rationale behind the punishment is deterrence, but if a person committed theft out of great needs, rather than greed, this principle became overuled.

2.3.5 The Equilibrium of Islamic Economics

One of the most crucial characteristics of Islamic economics is its state of equilibrium. This arises from the concept of moderation stressed by the *Quran* as "The middle Nation" (*al Ummat ul Wasat*) (2:143). With this "middleness" Muslims are called the best people ever evolved for mankind; as they enjoin the right, combat the wrong and believe in Allah (3:110). Accordingly, the approach of moderation or equilibrium extend to cover all aspects of Islamic economics, although our interest here lies primarily with the balance or the harmony between material and spiritual needs as well as individualism and collectivism.

1) Equilibrium between material and spiritual needs

Human existence is a synthesis of matter and spirit. One can only attain real success by maintaining them in balanced proportion. Both capitalism and socialism fail to realize the real welfare of man through their segregation of matter and spirit. They assume that the worldly success of man rests on nothing more than unbridled self-interest.

Only Islamic economics includes the two essential ingredients for real human welfare. (Abu-saud, 1984).

i) The fulfilment of man's physical and material requirements without suppressing his spirituality.

ii) The fulfilment of spiritual requirements.

It is essential to note, that Islam does not ignore material things. It maintains that spiritual elevation is to be attained by leading a pious lifestyle in simple surroundings but that the world should not be renounced.

Two important points arise from the above requirements:

a) A comprehension of the concept of worship

Muslims from both the *Quran* and the *Sunnah* understand that any work performed with good intention in accordance with the *Shariah* principles should be apprehended as worship upon which Muslims must be rewarded in the hereafter.

Allah has combined in the following verse:

> *"Wealth and children are an adornment of the life of this world; and the ever-abiding, the good works, are better with your lord in reward and better as the foundation for hopes."* (18:46)
>
> *"And seek by means of what Allah has given you the home of the hereafter, and do not forget your portion of this world.."* (28:77)

The prophet has also inspired people to work saying:

> *"If the last hour strikes and finds you holding a seedling in your hand, go ahead and plant it ... There is no better or nobler food than that which is provided by the work of one's own hand ... whoever returns home at the end of the day exhausted from his application and effort in his hand work, will be forgiven by Allah ... The hand which shows the effect of hard work is worthy of being kissed."* (quoted from: *Faruqi*, 1980, pp.79-102)

Thus the belief in Islam is not abstract in its nature it is linked with rightious work as a guarantee for an optimal production and a fair distribution of wealth.

b) The concept of the comprehensive control

In secular economic systems, only the mechanism of material control is considere d important. This is exemplified by the laws and decrees (that have been) laid down by man (as a human being).

In Islamic economics, Muslims are committed to two types of control; Firstly, external control which stems from the Islamic Shariah and its judgements; The second type is the internal control, which advocates a fear of Allah and stems from the "*hadith*"; "you have to worship Allah as if you really see Him, though you don't see Him, He sees you" (al-Nawawis' Forty Hadith).

The "*hadith*" impresses the idea that a good Muslim should be accountable before Allah, as mentioned earlier. Furthermore, it reminds the Muslim that if it is possible to avoid the punishment of the law in this life, it is not in the day of judgement and the after life. This concept induces pious Muslims to work hand and well. The *Quran* says:

> *"...and say (righteousness) soon will Allah observe your work, and His Apostle, and the Believer. Soon will you be brought back to the knower of what is hidden and what is revealed: then will He show you the truth of all that you did".* (9:105)

2) The Balance between individualism and collectivism

Another unique feature of Islam is that it has established a balance between individualism and collectivism - that is to say an equilibrium between the interest of the individual and the interest of the society.

It is widely accepted that capitalism is based on the assumption that the individual is an inviolable being whose freedom must not be socially restricted. Alternatively, socialism is grounded on the belief that the community is the fundamental basis and that the individual has no separate existance of his own. Consequently socialism renders every thing unto the State (as a representative of the community) and thus deprives the individual of his natural rights. Islam is comprised of totally different social concepts, and therefore adopts a different economic system. This system offers a distinctive role for the individual. This role is based on the three following concepts.

i) The concept of limited freedom

In Islam, the individual enjoys his own freedom in many spheres of life; the right to work, the freedom of speech (expressing his own opinions) the freedom of belief, the freedom of education; and the freedom to select his own profession. (Muslehuddin, 1974)

Thus, every Muslim benefits from his economic freedom - however this freedom is not absolute since it is governed by moral and ethical values.

In an Islamic economy, two types of restrictions of the economic freedom can be distinguished. (al Sadr, 1981)

- Personal restriction - this can be easily comprehended through "spiritual and moral content" - as mentioned earlier - i.e., every individual should expend maximum effort in prescribing a divine mission for himself. This by implication, demonstrates that he should be restrained in his activities by the internal control.
- The exogenous restriction - this is an expression of an external power which defines and regulates social behaviour.

The objective restriction of freedom in Islam is based on the principle that there can be no freedom for an individual if he contravenes the ideals and objectives of Islam. That is to say that individual freedom operates within the ethical bounds of Islam and is only sacred if it does not conflict with the larger social interest or if the individual does not infringe the rights of others. (Chapra, 1979).

ii) The concept of responsibility

The Islamic notion of responsibility is the exact antithesis of unlimited freedom. It comprises two important aspects. The first is man's responsibility before Allah - since man should be questioned come the day of judgement. The second aspect stresses his responsibility towards society.

In fact, the responsibility of the individual becomes clearer since the commanding presence of Allah alone heightens the awareness of each individual to his social duties. (Irving, 1974). On an individual level, responsible action is encouraged and positive behaviour is preferred to negative or destructive conduct

Muslims are promised:

> *"whoever brings a good deed, he shall have ten like it, and whoever brings evil deeds, he shall be recompensed only with the like of it and they shall not be dealt with unjustly" (6:161)*

Hence, every Muslim has an obligation to improve his socio-economic environment.

iii) The concept of Islamic rationality

Economic behaviour in Islamic society cannot be comprehended without reference to the Islamic ethics which govern it. The Islamic paradigm of individual behaviour depends on the essential concept of "*Islamic rationality*". This concept compels Muslims to adhere to the principles of *Shariah* in their economic activities. It is in this sense that "*Islamic man - homo Islamicus*", in the opinion of some Muslim economists, draws on his moral resources and acts in accordance with the ultimate ethical values. In sharp contrast, economic man "*homo economicus*" is motivated by self-interest and indulges in personal preferences. See (Arif, 1985b) and (Hamouri, 1987)

Addressing the relationship between individual and public interest raises an important question; how does Islam bridge the apparent contradiction between the two different interest types? The answer can be summarised lucidly by the following points:

- The objective of Islamic economics is principally the welfare of all (*al maslaha*). Islamic economics as a component of the totality of Islam lays particular emphasis on the welfare of the human being. This feature has been expressed by Muslim Jurists as: "*where there is welfare, there is the law of Allah*" (see Zidan, 1982).
- Originally there is no contradiction between the individual and the public interest. Islam does not divorce individuals from society, nor does it regard them as two opposing forces which are constantly striving to overcome each

other. In normal circumstances a great harmony must be achieved without sacrificing either interest for the good of the other.

- In cases of conflict, public interest takes precedence over the interest of the individual.

The economic system of Islam is grounded on this concept of harmony which should be attainable in every day affairs. In the event of an emergency (when conflict between individual and social interest is unavoidable) the following fundamental principles must be obeyed (quoted by Chapra (1979) from Abu Zahra (1957) and Dawalibi (1965): a) The greater interest of society takes precedence over the interest of the individual. b) Although '*relieving hardship*' and '*promoting benefit*' are both among the prime objectives of the *Shariah*, the former takes precedence over the latter. c) A bigger loss cannot be inflicted to relieve a smaller loss or a bigger benefit cannot be sacrificed for a smaller one. Conversely, a smaller harm can be inflicted to avoid a larger harm or a smaller benefit can be sacrificed for a larger benefit.

2.4 The Objectives of the Islamic Economic System

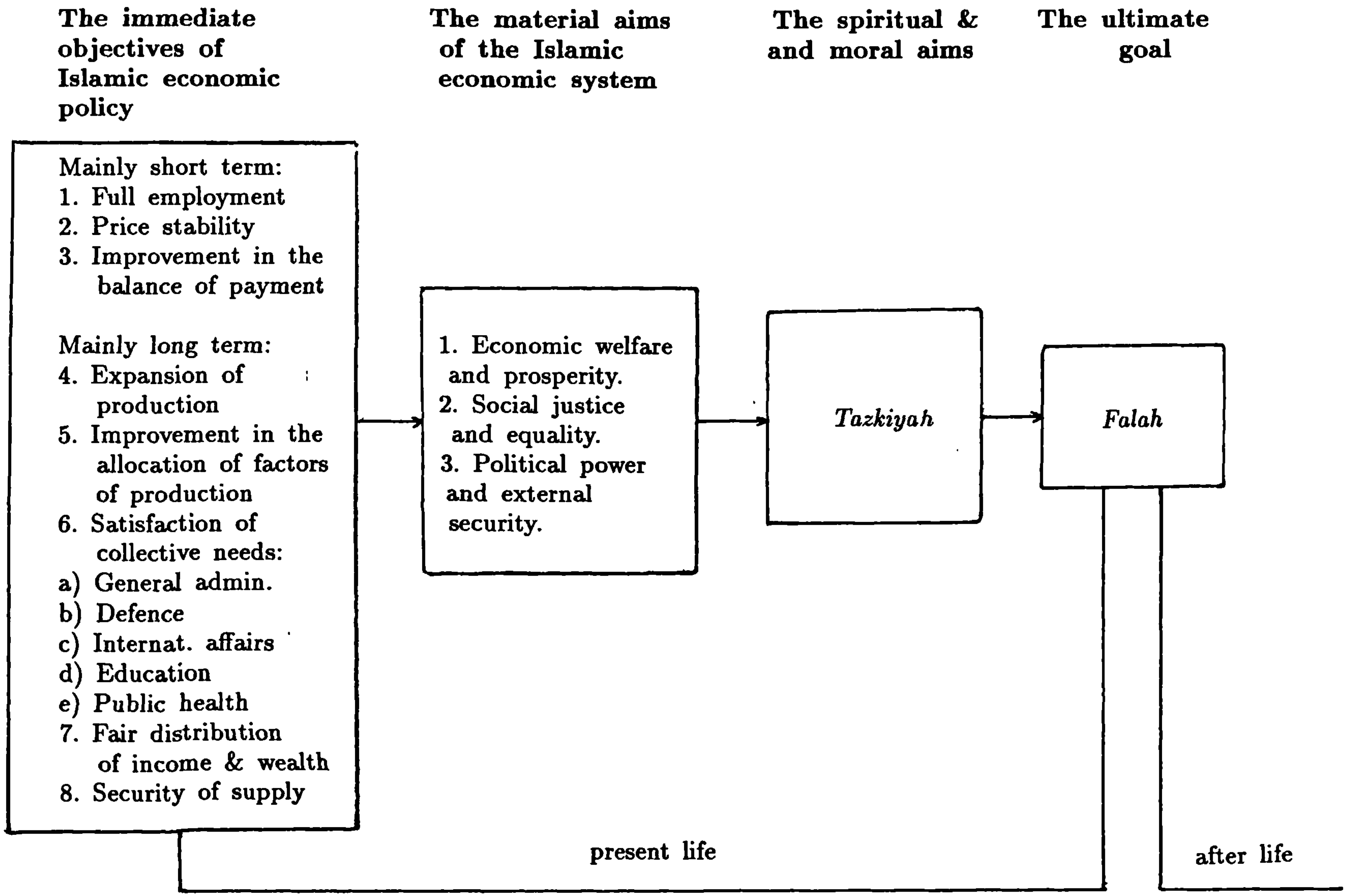
2.4.1 General Framework for the Objectives

Muslim economists have formulated various classifications of the aims and the objectives of the Islamic economic system. A brief appraisal will be given but it is first expedient to note the following:-

- The classification of the aims and objectives given here has been derived from the Islamic perspective (based on the *Quran*, the *Sunnah* and the *Ijtihad* of Islamic economists) (see Chapra 1979 and El-Hawwari 1982), as well as those of contemporary economic systems (discussed in numerous advanced studies) (e.g., see Wannaott (1979); Carson (1973); Montias (1976) and Kirschen & Morissens (1974))

- According to the classification suggested here, the ultimate goal of economic activity in Islam is to achieve *falah* - this can be achieved by maintaining both the material and the spiritual aims as specified in Chart 2.1.

Chart 2.1 : The objectives of the Islamic economic system.



- All the aims given in each category are expressed by the objectives - these in turn reflect the purpose of the actions instituted by the government in an Islamic economy and constitute the economic policy.

- The classification does not include all the objectives which may be apparent in an Islamic economy at a certain time. The number of objectives in the classification is kept to a minimum by omitting the finer details so that it can be handled more easily.

- The classification of objectives is shown in the first column of Chart 2.1. These objectives lead to a vital set of aims in society. This is metaphorically expressed as (material aims) depicted in Column 2. This set of aims leads on to the moral and spiritual goals (*Tazkiya*) shown in Column 3. Through these aims Muslims can achieve falah, the ultimate goal.

- There is a considerable overlap between the aims and objectives. This, however, will be ignored for purposes of simplifcation and ease of understanding.

- Since it is not the task of this thesis to discuss in any great depth the objectives of Islamic economics, only the ultimate goal and the aims will be very briefly considered:-

1) The ultimate goal (*falah*):

The ultimate goal of economic activity in Islam as part of the mission of man on earth is to achieve *falah.* The term *falah* or its derivatives is used forty times in the *Quran.*

Falah covers both present life and the hereafter. Consequently it entails the achievement of salvation in the life hereafter through righteous work in the present life which is expressed through various economic, political and social actions. (see Khan, 1976)

A vital link between *falah* and *tazkiyah* can be visualized in the following aims.

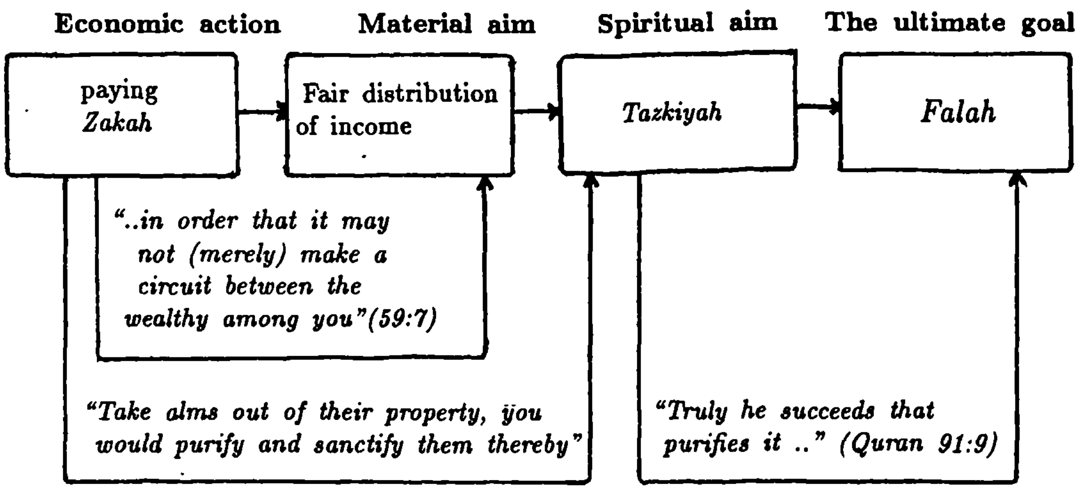
2) The moral and spiritual aims (*tazkiyah*):

As mentioned earlier, every single economic action in Islam possesses its own moral and spiritual dimension.

The *Quran* has described the spiritual consequences that arises from any economic action as *tazkiyah.* For example, the *Quran* states *"take alms out of their property, you would purify and sanctify them thereby" (9:103).* From this verse it is clear that purification and chastening i.e. *tazkiyah* - in addition to economic and social effects - is the substantial aim of the *Zakah.*

Since the *Quran* decrees that *falah* depends on *tazkiyah*; (truly he succeeds that purifies it (the soul) (91:9); (but those will prosper who purify themselves) (87:14), a basic series of aims can be formulated through the *Quranic* implications of *Zakah* as shown in Chart (2.2).

Chart 2.2 : The *Quranic* implications of *Zakah* (a series of aims)



Among the important consequences of *Falah* is the harmonious operation of economic and non-economic activities in order to achieve this noble aim

3) Economic welfare and prosperity:

Many verses in the *Quran* as well as the *Sunnah* demonstrate that a high rate of economic growth or economic prosperity should be among the economic goals of a Muslim Society since this would be the manifestation of a continual effort to use resources provided by Allah, for the service and betterment of mankind and thus helping in the fulfilment of the very object of their creation. (Chapra, 1979)

Since Islam seeks to purify life, it is prohibited to make material gain an end in itself, for example through the following mechanisms; by ignoring spiritual values, acquiring wealth through unfair means, or by exploiting others and subjecting them to wrong and injustice.

This is emphasised in many verses of the *Quran* and also in many *hadiths* of the prophet. It is beyond the scope of this study to discuss methods and plans which should lead to this aim through the various objectives shown in Chart 2.1. In economic terms such objectives include full employment, price stability, expansion of production ... etc.

4. Social Justice and Equality:

Since Islam views mankind as one family, all members of this family are alike in the eyes of Allah and before the law revealed by Him. There is no distinction made between rich and poor, or on any other socio-economic criteria involving personal status, e.g.

> "there shall be no discrimination based on race, colour or creed. The only valid criteria of a man's worth, are character, ability and service to humanity" (Chapra, 1979, p.13).

The Islamic image of social justice incorporates two general principles:

a) General Co-operation and Solidarity

Every Muslim, according to his individual means is responsible for the provision of the means of livelihood of others. It is incumbent upon all Muslims to implement this principle even in cases where there is no Muslim government to enforce Islamic law (al-Sadr, 1981).

Both the *Quran* and the *Sunnah* as well as the companions of the Prophet and the Muslim scholars emphasise mutual help and assistance in Islamic society. For example, the Prophet says: *"If any person/traveller? residing in a region spends the night hungry, the people of that region will fall out of the grace of Allah"* (Ahmed Ibn Hanbal). Imam Ali Ibn Abi Talib (the third caliph) is reported to have narrated:

> *"The right of the poor which has been prescribed by Allah in the wealth and property of the rich people is sufficient to meet the needs of the needy. If the poor people are still hungry and unclothed, it means that the rich have failed to give them their due right. Allah is empowered to question them on the day of resurrection and punish them"* (Quoted from *al Qaradawi, 1977, p.127).*

The famous statement made by Abu-Dhar, should also be taken into consideration:

> "I am amazed of one who does not find food in his house. How can he not fly out raising his sword to people? (Asking for his food)" (See al Fanjari, 1981, p.140).

b) Social Security

In Islam it is the responsibility of the government to ensure that all citizens lead a comfortable and respectable life. It is also prohibited for Muslims to be wealthy unless all members of society can satisfy their needs in adequate sufficiency.

With regard to the issue of economic justice in Islamic society, a fundamental question must be asked - should Islam achieve an equality of income among individuals or should the emphasis be on equality of opportunity? To address this question, two important points should first be noted:

i) Islam appreciates the differences between individuals in regards to their talents and capabilities.

ii) Islam considers "work" the principal component in its theory of income distribution.

Consequently, it is the government's obligation and duty to find gainful employment for the unemployed and *"just"* remuneration for those already in employment (Chapra, 1979).

As a consequence of these two points, it is clear that a disparity in income distribution between individuals will take place. Hence the Islamic stress on distribution does not entail an equality in the level of income, but instead guarantees a humane standard of living to all members of Islamic society (al-Sadr, 1981).

However, social security schemes within an Islamic state should aim at achieving a substantial reduction in income inequality in society. When an individual's income from work ceases or is interrupted the social security benefits must be fixed at a high enough level to provide a decent standard of living irrespective of income, occupation or sex. This is the teaching of the *Quran*, the practice of the Prophet and the example set by Islamic history. It is reported, for example, that Umar Ibn al-Khattab, (the second caliph after) was once passing by a place where he found an old Jew in a pityful condition. Umar enquired about the man and found out what his state was like. In a regretful tone he said to the man:

> *"We collected tributes (taxes) from you when you were able. Now you are desert and neglected. How unjust to you Umar has been!".*

After he finished his remark a regular pension for the old man was ordered and the order was made effective immediately. (Adopted from Abdalati, 1975).

The concept of social justice as constituting an important aim of Islam can be expressed through various objectives, as detailed in Chart 2.1. The most vital objectives are the achievement of full employment and a fair distribution of income - both of which should be achieved by use of the numerous instruments of Islamic economic policy.

5. Political power and external security:*

In spite of the clear relationship between *jihad* (the holy war) and the financial system which has characterised the Islamic experience throughout history, Muslim scholars and economists have paid little attention to political power and external security as an objective of the Islamic economic system.

* If the present day Muslim world is to be considered, this objective must be the achievement of political . economic and cultural independence.

The aim of social justice has been prominent in a large section of Islamic literature dealing with this field, however the crucial interaction between both the political and the economic system in Islam demonstrates that the political power and the external security of the Islamic society should be an important aim of the economic system. This can be expressed through different objectives as shown in Chart 2.1.

2.4.2 The Instruments of Islamic Economic Policy

It is beyond this research to distinguish here, which instruments are used for each objective of economic policy and which objectives are merely served by each instrument. Nevertheless the instruments of Islamic economic policy can be briefy categorized as follows:-

- Those instruments of public finance which incorporate public expenditure and revenue and also the budget.
- Instruments of credit which are based either on profit/loss sharing or the elimination of interest.
- The instrument of voluntary efforts which covers both monetary (i.e. *Qard hasan*) and fiscal (i.e. *Kaffarat*-expiations) issues.
- Instruments of direct control and state intervention - these possess the power to fix prices, quotas, etc. and a series of other actions.

2.4.3 Conflicts Between Objectives.

This conflict between economic objectives has been roughly discussed in contemporary economic literature - usually under the heading of the '*problem of preferences*'.

A common criticism is that, in most cases, the conflict operates between an objective served by increased government expenditure and/or reduced taxes (full employment, expansion of production, satisfaction of collective needs, improvements in income distribution, etc) and objectives served by reduced expenditure and/or increased taxes (price stability, reduction of deficits in the balance of payments etc).

Table 2.1 which is adopted from Kirschen and Morissens, (1974) shows some major conflicts which can be expected in an economy, be it capitalist, socialist or Islamic. However, the contradictions are much more intense in capitalism e.g. if wages in Islam are on a basis of profit sharing then this conflicts between redistribution of incomes and expansion of production etc. are less.

In an Islamic economy it is the Government's duty to remove this conflict between objectives and to present an order of priority. This duty must depend on two crucial concepts which are not present in either the capitalist or socialist systems:-

i) The concept of abundance or absence of scarcity which is peculiar to Islamic economics as mentioned earlier.

ii) The concept of worship. This includes man's economic activities which constitute the distinctive "production possibility frontier" of the Islamic society.

Table 2.1 : Main cases of conflicts between objectives in an economy.

	Price stability	Balance of payments	Expansion of production	Collective needs	Redistribution of incomes
full employment	x*	x			
price stability			x	x	x
balance of payment			x	x	x
expn. of production					x

* The x's indicate the most important conflicts between objectives which can be expected in an economy - as mentioned earlier - be it capitalist, socialist or Islamic.

2.5 Islamic Economics as an Integral Part of a Comprehensive System

As can be understood from the previous presentations, Islamic economics must not be conceived as an isolated or independent discipline. It is part and parcel of the supreme and comprehensive system of Islam.

It is not possible in this brief outline to pinpoint in detail all relationships and interactions between the economic and other systems in Islam, for the ramifications and the mutual relationships between all parts of the entire Islamic system constitute a veritable mosaic.

However, a brief investigation of the relationship between the economic and other systems in Islam can be conceptualized in the form of the diagram 2.3, from which the following connections can be distinguished:-

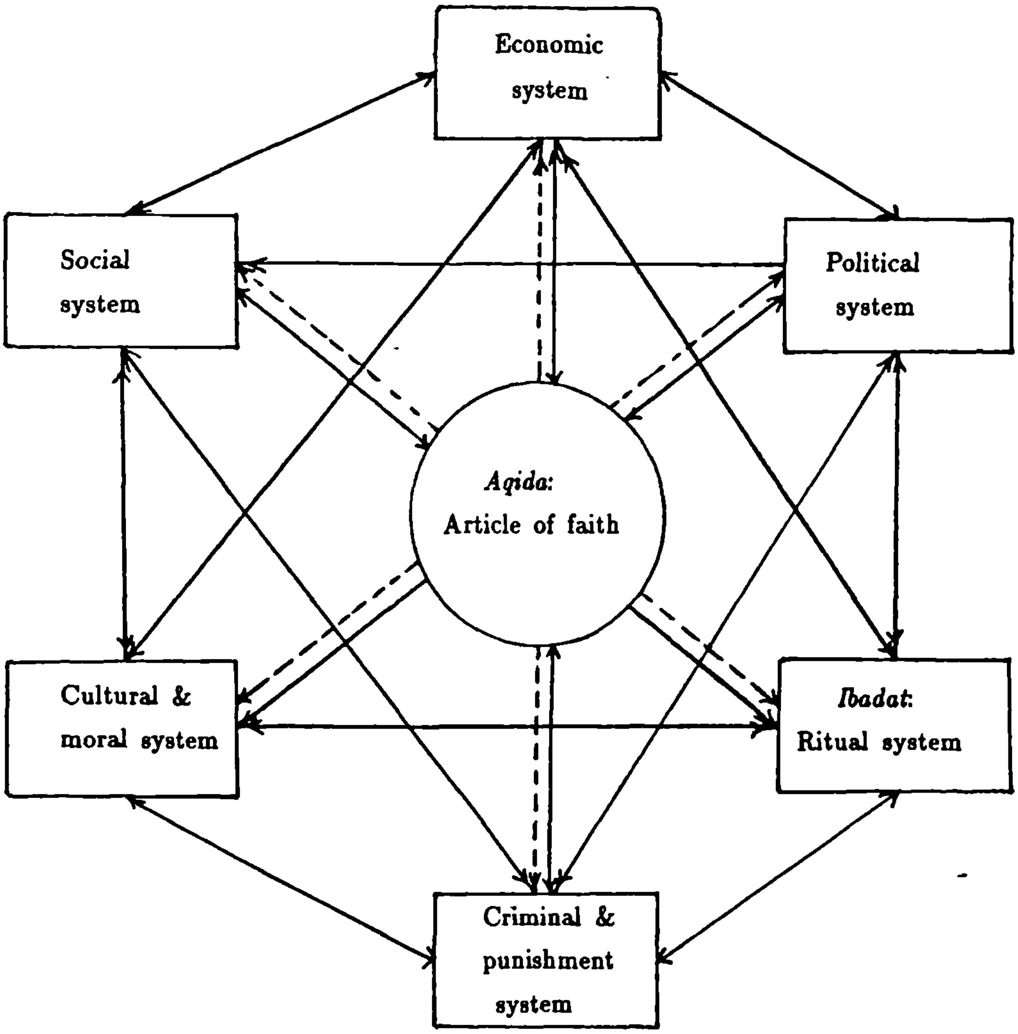
2.5.1 The Islamic Economic System and the Islamic *aqida* (the articles of faith)

It may be clearly understood by now, that the various phases of Islamic life and activity flow from the fundamental postulates of the Islamic *aqida* exactly as a plant sprouts forth from its seed. Even though a tree may spread in all directions, all its leaves and branches remain firmly attached to the roots and derive sustenance from them; it is always the seed and the root which determine the nature and the form of the tree. The case with Islam is similar.

It is clear from the previous presentation that the Islamic economic system is based on a solid foundation and the divine instruction of the Islamic *aqida* which penetrates deeply and constructively into every aspect of it. The *aqida* has a decisive effect on the spiritual and material life of a Muslim as well as those aspects of a Muslim's personal and social behaviour which are related to his economic and financial life. Since this is also the case with every other aspect of Muslim conduct, *aqida* commands a unique position on the whole issue. In Chart 2.3., it has been drawn as the central source which feeds and fosters all other systems in the chart.

On the other hand, the performance of the economic system also has its own impact on the *aqida* itself. For instance, poverty as a consequence of a badly operating economy has been classified from the Islamic viewpoint as a serious canker which adversely affects the faith and the belief of an individual and a society. The Prophet said, *"poverty may turn itself into unbelief"* (Abu Naim fil Hiliyah). Accordingly, the prophet was invoking Allah, saying: *"Oh Allah, I seek your refuge from poverty and hunger"* (Abu Dawud, Nisa'i and Ibn Maja).

Chart 2.3 : Islamic economic system as an integral part of the comprehensive system of Islam.



In the light of this tradition Sheikh al-Qaradawi (1977) said:

> "Of course, poverty puts man's faith to the test, especially when he is surrounded by wealthy people and the impoverished are engaged in hard work while the rich people sit idly nearby. In this precarious situation, poverty drags man into the depths of doubts on the workings of the Divine wisdom in administering the creation and distributing fairly the wealth among them" (p.13).

2.5.2 The Islamic Economic System and the Cultural and Moral System

As explained earlier, the dimensions of cultural and moral values in Islamic economics are numerous, far-reaching and comprehensive. They build up the character of the "*Islamic man*" mentioned earlier. They determine the whole performance of a Muslim; his behaviour and his manifest deeds, his words and his thoughts, his feelings, emotions and intentions.

Consequently in the absence of these lofty values, the attempt to apply Islamic economics in an abstract or arithmetical sense will not yield any valuable fruits.

In addition, Islamic economics largely contributes to the promotion of the cultural and the moral values within the society by insisting on honesty from all parties.

Fulfilling the needs of the members of the society and providing a decent standard of living through the different means defined by Islamic economics will prevent people from committing any unlawful acts. Moreover, the economic success/failure of man will also affect his intellectual performance. How is it possible for a person who is absorbed in securing food for his family to involve himself with intellectual matters or contribute constructively to the culture of his society. In line with this, Imam Abu Hanifa is reported to have narrated:

> "Don't consult a person who has no flour (i.e. food) in his house" (adopted from Qardawi, 1977, p.15).

This means that a needy person who lives in poverty will be intellectually distracted and his opinion would often not be correct and justifiable.

2.5.3 The Islamic Economic System and the Political System in Islam

Under the political system of Islam, the Islamic state is entitled to numerous powers as well as properties (public ownership) which enable it to effectively administer the affairs of society in accordance with the solemn contract over which Allah is the supervisor-between the administration and the public. Besides enforcing the *Shariah*, the state has a distinctive role in an Islamic economy in maintaining a healthy market ensuring the optimal allocation of resources, accelerating economic growth and assuring social justice and prosperity. (See; Sakr (1978), al-Sadr (1981), Siddiqi (1981)). On the other hand, it is common that the success/failure of an economic system affects the state of power/weakness of the political system. Thus when an Islamic state successfully adopts a self-sufficient economic policy for instance, this will undoubtedly contribute to its economic, political and cultural independence and help to solidify its international standing.

2.5.4 The Economic System and the Social System of Islam

The structure of social life in Islam is largely related to the concept of morality as stated earlier. Among the substantial elements of this structure are sincere love of one's fellow human beings, a genuine feeling of brotherhood and social solidarity and respect for the rights of other people's lives, property and honour. The social life of Islam is characterized by cooperation in goodness and piety which results in a sharing responsibility between the individual and society. This was illustrated earlier as a prerequisite for an effective operating Islamic economy. More relevant are the socially-oriented laws and injunctions which have economic implications. One example is the law of inheritance which is considered as a vital vehicle in the distribution of wealth in Islam.

The other face of the coin is that Islamic economics has a distinctive impact on the social life of the members of the Islamic Society. The imposition of *Zakah* or the prohibition of *riba* (interest) as well as many other implications of Islamic economics are undeniably dedicated to maintaining justice, welfare, and social solidarity within the Islamic Society.

2.5.5 The Islamic Economic System and Ritual System of Islam (*Ibadat*)

Although the economic activity of true Muslims has already been classified as worship (*Ibada*), the latter in this context, means the performance of the five pillars of Islam which are witnessing that there is no God but Allah and Muhammad is His messenger, prayer, paying *Zakah*, fasting the month of Ramadan, and pilgrimage to Makkah. While the practice of these rituals is the major source of inspiration for Muslims, they also have some economic implications in one way or another.

Zakah is a major element of these requirements of Islam which is explicitly classified as an economic and financial instrument. It is considered to be the central piece or the cornerstone of fiscal policy in Islam.

Zakah as a religious tax applies to various kinds of possessions at a certain rate (often 2.5 per cent for many types of wealth). In each category of wealth *Zakah* is payed by people whose holdings exceed a certain amount called *nisab* (the zakatable minimum). The beneficiaries of *Zakah* fall into several categories defined by the *Quran*:

> *"The poor, the destitute, the people who collect it, the new converts, the liberated of prisoners and slaves, the indebted in the course of Allah and the wayfarer" (9:60).*

Accordingly, while *Zakah* represents a prime source of revenue for an Islamic state it is however, not collected to finance the expenditure in the state budget as is practised in contemporary public finances. The allocation of the *Zakah* resources is restricted for its intended purposes based on a margin of *ijtihad* established by the phrase "and for the cause of Allah" which has a wide and flexible meaning. (al-Qaradawi, 1981) Without going into the minute details of *Zakah* it must be noted that its religious and spiritual significance is far-reaching, although it is a fiscal manifestation. It is not just a form of charity or alms giving or a tax. Nor is it simply an expression of benevolence, it is all of these combined and much more. It assumes a religious sanctity and humanitarian, economic and socio-political value. To understand Islam's emphasis on *Zakah*, Abu Bakr's (the first Caliph) fighting against the people who refused to pay *Zakah* after the Prophets' death is the most vivid precedent to be considered.

Before launching his expedition he addressed the public saying:

> "By Allah, I will wage war against those who discriminate between salah (prayer) and Zakah". (al-Bukhari, adopted from Mannan (1986)).

Thus when Muslims who are supposed to adopt Islamic economics fail to observe *Zakah* as a fiscal worship they are committing a grave offence and a hideous sin. This offence is not only against Allah' *Shariah* but also against the interest of Muslims themselves. They will be largely deprived of the valuable contribution of *Zakah* and Islamic economics to their well-being and prosperity. One example of such a state of welfare can be found during the Caliphate of Umar bin Abdul Aziz (99-102 A.H. / 717-720 A.D.) when there was none eligible to accept *Zakah* as all the members of the society had enjoyed a venerable standard of living with their needs fully satisfied (al Qaradawi, 1977).

2.5.6 The Islamic Economic System and Criminal Punishment System in Islam

It is clear from the previous presentation that there is an inseparable connection between the state of welfare of the society and the Islamic laws of punishment (*the hudud*). Just as the *Shariah* prescribes that the hand of the one who steals must be cut off, it prescribes as equally important that the needs and necessities of the individual must be fulfilled by the society. It is only when the society fulfills this duty towards the individual, that the latter's theft should be regarded as a criminal agression against the welfare of the society; one worthy of severe punishment. Accordingly, applying the law of punishment (*the hudud*) to poor people as is the case in the contemporary Muslim world, in Sudan under Numeiri for example or in Saudi Arabia is an Islamically unjust state of affairs. It is extremely alien to the spirit of both Islam and its legislation. It is clear in both these cases, that punishments are restricted to the poorest people rather than the rulers or ruling classes and the politically powerful and wealthy. Islam has never conceived, for example, the enforcement of its law to cut off a person's hand without fully implementing economic and social policies which guarantee the satisfaction of his needs. One may ask, how such a law can be enforced in an interest-based economy, characterized by unequitable distribution of wealth under authorities which are unaccountable to the public.

In conclusion, the Islamic economic system is an integral part of a coherent system covering all aspects of Muslims life. In the words of al-Mawdudi mentioned earlier, it is one branch of the deep-rooted tree of Islam.

Consequently, any attempts to apply Islamic economics in isolation from this context will not bear any promising fruit. According to Naqavi (1985):

> "The basic proposition of Islamic economics can be valid only within the framework of an Islamic system, of which ethics form a dominant component" (p.30)

Most critical, hence, will be the introduction of any part of Islamic economics such as Islamic banking or *Zakah* in an indifferent environment clearly characterized by the violation of Islamic values. If Islamic economics is seen as a branch of the tree of Islam, Islamic banking for example is just a mere leaf whose survival away from its branch or its mother tree is a miracle.

Chapter III

The Theory of *Riba*

3.1 Introduction

The purpose of this chapter is to provide a concise but rigorous introduction to the study of *riba* in Islam. It will specifically be concerned with the Islamic view of *riba*, but should also investigate the development of western economic thought towards interest as well as a number of misgivings about its prohibition in Islam. For this purpose, this chapter is divided into three major sections (apart from this introduction). In the first section the meaning and the types of *riba* are briefly but clearly analysed. In the second section, account is taken of the prohibition of interest in western economic thought and the misgivings about its prohibition in Islam, under the major heading: *riba* and interest. The third section contains the rational for the Islamic prohibition of *riba* emphasizing the serious effects of interest on investment, consumption and public debt.

3.2 The Meaning and the Types of *Riba*

3.2.1 The Meaning of *Riba*

Riba, literally means increase (*ziyadaha*) and growth (*nama'*). (Ibn Manzur's Lisan al-Arab, 1968 (reproduced), Vol. 14, pp.304-7). It must be noted, however, that Islam does not prohibit every increase or growth.

In the *Shariah*, there is no agreement among the *Ulama* from the different schools of *fiqh* (*Madahib*) on a single definition of *riba*. Nevertheless, *riba* technically refers to "the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity" (Chapra, 1985, pp.56-7). In this sense, *riba* contains three elements; an increase over the principal amount of a loan, determination of this increase in relation to time, and stipulation of this increase in the loan agreement. Accordingly, any deal or bargain on credit transactions in money or in kind which contains these three elements is considered a *riba* transaction by Muslim scholars (see, al Mawdudi, 1961).

3.2.2 The Types of *Riba*

Despite their diverse phraseologies concerning the types of *riba*, almost all Muslim *ulama* agree that *riba* is practiced in two major forms, namely *riba al duyun* (*riba* in debts) and *riba al buyu* (*riba* in sales). These two sorts of *riba* will be discussed as follows:-

3.2.2.1 *Riba* in debts (*riba al duyun*)

Riba in debts implies that any specified or unspecified (i.e. an absolute amount or a variable percent of the principal) reward (e.g. money, gifts, services) to be paid in advance or on maturity or as a condition for loan from the borrower to the lender is prohibited by *Shariah*. This means that this type of *riba* includes every increase to the principal amount of the debt, regardless of whether it has arisen from a loan or a deferred payment sale or otherwise. Muslim scholars, however, have dealt with this sort of *riba* under different names such as:

- *Riba al nasiah* (deferred payment); the word *nasi'ah* comes from the roots *nasa'a* which means to postpone, defer, or wait.

- *Riba al jahiliyah* (the pre-Islamic era); provided that this *riba* was practiced by the pagan Arabs before Islam.

- *Riba al qurud* (*riba* in loans), which is almost the same as *riba al duyun*, since a *qard* (loan) is also *dayn* (Debt).

- *Riba al Quran*, as this sort was explicitly prohibited by the *Quran*. A more appropriate name however, would be 'the *riba* prohibited by the *Quran*'.

- *Riba aljali'* (overt *riba*). This concept was developed by Ibn al Qayyem (mentioned earlier) referring to *riba* in deferred payment which had been practiced in the pre-Islamic era and was strictly prohibited by the *Quran*, vis-a-vis the covert *riba* which was banned by the *Sunnah* (see Ibn al Qayyem, 1955 -

reprinted). In the light of the above, it is important to examine the prohibition of *riba al duyun* by the *Quran*. This prohibition came in four stages as follows:

1. The preliminary stage:-

The first verse concerning *riba* prohibition in the *Quran* was revealed in Makkah in *Surat al Rum* (Chapter 30).

> *Verse 39: "And whatever you lay out by the way of riba, so that it may increase upon people's property increases not with Allah, but whatever you give in charity, seeking the pleasure of Allah, will receive recompense manifold".*

In their interpretation of this verse, most commentators are of the opinion that *riba* in this verse refers to a donation or a gift given by a doner who waits in return to receive a better gift or reward as was practiced in the time of revelation (see Qutb, 1980). However, it appears from the verse that in this phase *riba* was not strictly prohibited. Hence, at that early period of Islam, the *Quran* was merely preparing the souls of people for the strict prohibition of *riba* which comes later. This preparation was through the encounter between *riba* and charity saying that those who seek their reward in the hereafter through alms giving are better than those who seek reward in this life by increasing wealth through *riba*.

2. The stage of the indirect warning:-

In this stage the *Quran* narrated the status of Jews and the punishment that they faced when they were asked to abandon *riba* and chose to violate the restrictions ordained by Allah and took it. In *Surat al Nisa'* (Chapter 4) verses 160 and 161 of the *Quran* states:

> *"wherefore for the iniquity of the Jews did we disallow to them the good things which had been made lawful for them, and for their hindering many (people) from Allah's way. And their taking riba though indeed they where forbidden it and their devouring the property of people falsely, and we have prepared for the unbelievers from among them a painful chastisement".*

In line with the previous stage, the above two verses did not establish an explicit prohibition of *riba*. Their main concern was to tell people about the retribution of Jews who disobeyed Allah in taking *riba* though it was disallowed for them to do so, however, they implied an indirect guidance and warning to Muslims concerning the undesirability of *riba*. In other words, they were a hint which aimed at preparing people to accept the explicit prohibition of *riba* which came in the following phases.

3. The stage of the explicit but not the complete prohibition of *riba*:-

In *Surat aal Imran* (Chapter 3), verses 130-133, the *Quran* states:

> *"Oh you who believe do not devour riba doubled and multiplied and fear Allah; that you may (really) prosper."*

In this stage the verses only emphasised the prohibition of the doubled and multiplied *riba* (*riba al Adha'af al Mudhaa'fah*) which was prevalent in the pre-Islamic Arabia. Thus this explicit ban which was established by these verses was a crucial step towards the complete prohibition which was laid down in the fourth and the final stage of *riba* prohibition.

4. The stage of the complete prohibition:-

In this stage *riba* was strictly prohibited when the complete ban was laid down through the following text (*Surat al Baqarah* (Chapter 2) verses 275-279):

> *"Those who devour riba will not rise except like the one who has been struck by the devil's touch. That is because they said bai (trading) is just like riba but Allah has permitted bai and prohibited riba ... Allah deprives riba of all blessings but He gives increase for deeds of charity ... Oh you who believe, fear Allah and give up whatever remains (due) from riba if you are indeed believers. But if you do (it) not, then be apprised of war from Allah and this Apostle; but if you desist you shall have your capital sums; deal not unjustly, and you shall not be dealt with unjustly."*

Having considered both the spirit and the history of Islamic legislation, it appears that the above verses were revealed by the spiritual and the intellectual ripeness of the Islamic society. Only in this context could the society be induced to satisfactorily accept the prohibition of *riba*. Indeed, it was difficult if not impossible for a commercial society to foresake the well-established system of *riba* immediately. The course of time was necessary for people to believe in Islam itself whereupon the prohibition of *riba* would easily be attained (Abbas, 1987). In fact, at this stage, the legislation of *riba* has been completed and the moral instructions which will guide Muslims in their credit transactions have already been established. The most important of these guiding lights are the following.

- All those who are involved in *riba* transactions are to be severely condemned. This is understood from the wording of the verse "*Those who devour riba...* etc."

- Following the above condemnation, those who are involved in *riba* will face a severe punishment by Allah. This is partially expressed by the verse "*...then be apprised of war from Allah and his Apostle ...*"

- The above verse puts responsibility on the Muslim ruler to ensure the ban of *riba* and to root out all its forms from the society through enforcing the iron fist policy against those who deal in it. This can easily be understood from the Quranic sentiment that the war against those dealing in *riba* is to be also launched by the prophet, in addition to the war from Allah.

- All properties which are involved with *riba* will lack the blessing of Allah and in one way or another, sooner or later they will be demolished. Allah says, "*Allah will destroy riba*".

- In contrast, Allah will bless all efforts and properties which involve charity or alms giving. This is emphasised by the *Quran*ic phrase "*... He gives increase for deeds of charity.*"

- The Islamic alternative to *riba* has been established in the institution of *bai* which will be discussed later. This came through the rejection of the pagan Arab's claim that "*bai* is just like *riba*" and the formulation of the truth that "*Allah has permitted bai and prohibited riba*".

- One fundamental principle which remains to be highlighted is that the moral and intellectual change must preceed the introduction of any aspect of Islamic economics in such corrupted societies as those of the present day Muslim world. This is already conceived through the gradual prohibition of *riba* and can further be confirmed through investigating the modes of the verses of the *Quran.*

Having surveyed all the verses which start with the phrase "*Oh you who believe ...*", it is found that there are 87 verses. Apart from the verse of *riba* in *Surat al Baqara* (No. 278) there are only four verses which imply the address "*Fear Allah*" or "*have fear from Allah*". It is revealed that such verses however, have laid down only general orientations without establishing any legislative judgement "*hukm shar'i*". One example is the verse "*O you who believe, fear Allah as He should be feared and don't die unless you are in a state of Islam*" (3:102) Thus, the verse of *riba* remains to be the only one amongst the legislative verses "*Ayat al Ahkam*" which implies the address "*Fear Allah*" saying that "*O you who believe, fear Allah and give up whatever remains (due) from riba ...*". In other legislative verses the injunction is directly expressed following the address "*O you who believe*" without telling "*Fear Allah*". An example for this is the verse "*O you who believe make not unlawful the good things which Allah had made lawful for you ...*" (5:87)

The indispensable conclusion of the above argument is that the fear from Allah, the purification and the complete submission to His will must precede the undertaking of any economic or financial practice based on Islam.

3.2.2.2 *Riba* in sales (*riba al buyu*)

This type of *riba* was neither known to Pagan Arabs nor prohibited by the *Quran.* Its prohibition, thus has arisen from the *Sunnah* or the sayings of the Prophet (Abu Zahra, 1970).

The position of the sunnah on *riba* was, therefore, conceived as to emphasis the prohibition of the *riba* in debts on the one hand and to establish the prohibition of the *riba* in sales.

Having broadly condemned *riba* the Prophet had warned against any involvement whatsoever in it. From Jabir, the Prophet, cursed the receiver and the payer of *riba*, the one who records it and the two witnesses to the transaction and said "*They are all alike (in guilt).*" (Narrated by Muslim, Tirmidhi and Ahmed). The most vehement condemillionation of *riba* made by the Prophet, however, was that in which he described *riba* as greatly sinful as more than adultery. From Abdullah Ibn Hanzalah: The Prophet said: "*A dirham of riba which* *a man receives knowingly is worse than committing adultery thirty six times*" (Narrated by Ahmed, Daraqutni and Bayhaqi).

This tradition of the Prophet indicates an indisputable fact that the social injury of *riba* cannot be restricted to dealers therein only; the damage and evil it causes extends to the whole society. It is because of this the Prophet considered it more serious than adultery which primarily affects the person who commits it, although it is also a grave social disease.

As far as the prohibition of *riba al buyu* which is stipulated by the *Sunnah* is concerned, Muslim *Fuqaha* have distinguished two kinds, namely:

i) The unequalized exchange *riba* (*riba al-fudl*) which is realized when an item is exchanged for its kind with an increase in quantity.

ii) The deferred delivery *riba* (*riba al-nasa'*) which is when an item is exchanged for an item of its kind or of another kind which has the same *Illah* (the reasoning of judgement) in relation to *riba* with a deferred delivery.

Since the prohibition of both kinds of *riba al buyu* is ascribed to the *Sunnah* it is important to discuss it within the latter's context. Although a variety of *ahadith* were narrated in relation to this sort of *riba* the two most important ones are the following:-

- From Ubada Ibnus-Samit, the Prophet said:

  "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, equal for equal, and hand-to-hand; If the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand."(Mentioned in al-Sihah except al Bukhari).

- From Abu Sa'id al-Khudri: The Prophet said:

  "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, and hand-to-hand. Whoever pays more or takes more has indulged in *riba*. The taker and the giver are alike (in guilt)."(Agreed by the six books of al Sihah)

It is clear from the above texts that if gold, silver, wheat, barley, dates, and salts are exchanged against themselves, they should be exchanged on the spot and be equal and alike. In the discussion of this kind of *riba* three important questions need to be answered. The first is what is the rationale behind the '*spot exchange*' of an item for its counterpart as suggested by the above texts. The second is what are the main rules which can be inferred from these *hadiths* to bar *riba* from lawful transactions. The third and the final question is *riba* in sales restricted only to the six commodities which are mentioned in the ahadith. The answers are as follows:-

1. The rationale of the suggested exchange:-

According to Chapra (1985, p.59),

> "On the surface it appears hard to understand why anyone would want to exchange a given quantity of gold or silver or any other commodity against its own counterpart, and that too is 'spot'."

Answering this question he further stated:

> "What is essentially being required is justice and fairplay in spot transactions; the price and the countervaluc should be just in all transactions where cash payment (irrespective of what consitutes money) is made by one party and the commodity or service is delivered reciprocally by the other."(p. 59.)

Despite the emphasis he made on justice, it seems quite clear that the question concerning the rational and the justification of the suggested exchange remains unanswered.

In a further developed argument made by Abbas (1987, p.46), he clearly points out that,

> "Of course, no man of wisdom will exchange on the spot, one kilogramme of wheat for a similar kilogramme of wheat. Therefore the above tradition is only meaningful if it is interpreted to refer to different amounts of the same kind of goods. The tradition reveals that exchange of different amounts of the same kind of goods are prohibited."

However, this argument also seems insufficient to provide a clear answer. For further clarifiction of the picture, thus, two more important points are made here:

i) It is well-known in economic history that the economy in the Prophet's era had operated according to the barter system. Under this system, both gold and silver, as precious metals, were handled in different forms (i.e. coins*, ornaments or knick-knacks ... etc.) with weight being the sole criteria of exchange.

Now, while it is difficult to understand how and why a person for example might be able to exchange 100 g. of gold in coins for 120 g. in return of the same, it seems quite understandable if the last weight of gold was in a different form, e.g., jewellery, in such a state of affairs there is a great possibility of unequal exchange. Accordingly, the Prophet had blocked the road leading to *riba* which arose from this sort of transaction emphasising equality in weight as the benchmark for this exchange. In line with this, it is narrated by Fadalah Ibn Ubayd al-Ansari: On the day of Khaybar he bought a necklace of gold and pearls for twelve dinars. On separating the two, he found that the gold itself was equal to more than twelve dinars. So he mentioned this to the Prophet who replied: "*It (jewellery) must not be sold until the contents have been valued separately*". On the authority of Sahih Muslim the Prophet added "*Gold for gold, weight for weight*" (Sahih Muslim).

ii) As for the other commodities of food mentioned in the *hadith* (wheat, barley, salt, and dates), it can be said that the search for a better quality is likely to be the motive behind the spot exchange of an item for the same of its kind with an increase or addition. Thus, it can be said that it seems understandable if a person barters one kilogram of a specified quality of dates for two kilograms of a finer quality date. This exchange, however was also deemed *riba* by the Prophet, emphasising quantity as the sole criterion of exchange regardless of any other aspect. This can be confirmed by the *hadith* of Abu Sa'id who stated that:

> "Bilal brought to the Prophet some good quality dates whereupon the Prophet asked him where these were from. Bilal replied: "I had some inferior dates which I exchanged for these - two *sa's* (a measure) for a *sa'*." The Prophet said, "*Oh no. this is exactly riba, do not do so. but when you wish to buy, sell the inferior dates (against another commodity) and then buy thr better dates (with the price you receive).*" (Sahih Muslim and Musnad Ahmad).

* Since gold and silver were not accepted as the sole medium of exchange (i.e. standard money), it is not possible to precisely differentiate between the demand for them as for transaction purposes and that for the precious metals as artifacts.

2. Rules governing *riba al buyu.*:-

Muslim *Fuqaha'* deduced from the forementioned *hadith* and others related to this kind of *riba*, the following rules governing it:

i) When exchanging metal for metal of the same type (e.g. silver for silver) and food for food also of the same type (e.g. dates for dates), two conditions should be fulfilled to avoid *riba*:

   - Equality between the exchanged commodities quantitatively and qualitatively, "... like for like, equal for equal..."

   - Spot transaction or prompt delivery "hand-to-hand". Failing to meet the first condition causes *riba al fadl*, the absence of the second condition leads to *riba al nasa'*.

ii) When exchanging metal for metal of different goods (e.g. gold for silver) and food for food also of different goods (e.g. wheat for barley) the lawful exchange is subject to only one condition which is it must be a spot transaction; equalization is not a condition.

iii) In the case of exchanging metal for food such as gold or silver for wheat or barley, no conditions are required, and free exchange can exist whether it is spot or forward, equal or unequal in quantity. These exchange conditions can be summarized in Table (3.1) which was initially suggested by al Misri (1977, p.157).

3. Commodities subject to *riba*:-

This is to answer the third aforementioned question of whether *riba al buyu* is only confined to the six items mentioned in the Prophet's sayings or if it can be extended to any other commodities. For this purpose, Muslim *fuqaha* have discussed the *Illah* (the reasoning) of the *riba* concerning both the metals and the food commodities mentioned in the *Hadith.* The controversy about the wisdom of the prohibition of *riba al duyun* as well as the different opinions of the different schools of *fiqh* on it's *Illah* can be summarized as follows:-

Table 3.1: A Representation of *Riba* in the *Hadith*

		Precious Metals		Food Provisions			
		Gold	Silver	Wheat	Barley	Dates	Salt
Precious Metals	Gold	**	–	n	n	n	n
	Silver	–	**	n	n	n	n
Food Provisions	Wheat	n	n	**	–	–	–
	Barley	n	n	–	**	–	–
	Dates	n	n	–	–	**	–
	Salt	n	n	–	–	–	**

Key:
- ** equalization and spot are required
- – only spot is required
- n nothing is required

i) The *Illah* in gold and silver.

The *fuqah* differ in their reasoning of the prohibition of *riba* in the two currencies (gold and silver) as follows:

- The opinion that the *Illah* is confined to gold and silver regardless of their form being crude, manufactured or in coins. This is the opinion of the Zahiri school which negates *qiyas* (anology).

- The opinion that the weight is the *Illah* of the prohibition. This is favoured by both the Hanafis and the Hanbalis. It is also accepted by the Ja'faris and the Zaydis. In their opinion, this rule applies to any weighable commodity whether it is iron or cotton. This means that when trading gold for gold or cotton for cotton the traded amounts should be equal in weight (to avoid *riba al fadl*) and transaction should be spot (to avoid *riba al nasa'*). While this opinion can be criticized on the grounds that it applies to weighable proportion other than currencies (gold and silver), more important is the fact that it fails to address the characteristics of present day currencies. It would not be acceptable to argue that paper money in which people deal nowadays are *riba*-free since they are weightless.

- The opinion that the *Illah* is "the predominance of the value-measuring characteristic" (*Ghalabat uth-Thamaniyyah*) of both gold and silver. This argument was developed by both Shafi's and Malikis who said that the *Illah* lies in gold and silver because both are acting as a medium of exchange and as a measure of value of all other things. According to them, since the attribute of value-measuring is limited to only gold and silver, *riba* does not apply to any metals other than them. This means that this opinion is not different from that of the Zahiris stated above. This opinion of the Shafis and Malikis was criticized by the Hanafis who said in one of their arguments as narrated by al-Nawawi (d.676/1277) that:

  - The *Illah* (of Shaf'is and Malikis) may exist without having a prohibition being established. An example of this is the *Fulus* (a unit of currency) which according to them (Shafi's and Malikis) are not subject to *riba*

  - A prohibition may be made without having their *Illah*.

An example of this is gold and silverware where *riba* is banned although they are not measures of value. (See Homoud, 1982, p.172).

Thus, it seems that the 'predominance of the value-measuring characteristic' which was demonstrated by Shafi's and Malikis as the reasoning of *riba* is no differeent from the previous reasoning of weight, which is being incapable of covering the present day dealings in currencies.

- The view that 'legal tender' (*Mutlaq uth-Thamaniyyah*) is the *Illah* of the prohibition of *riba* in currencies. This has been referred to by the three Imams, Abu Hanifah, Malik, and Ahmed in one of their less known statements and adopted by Shaikh al Islam Ibn Taymiyyah, his disciple Ibn al Qayyim, and other *Ulama* (see Ibn Mani', 1971, p.107).

According to this argument, any vehicle which can be used as a medium of exchange and a measure of value is exposed to the dangers of *riba.*

In the light of this view it can be said that the paper money of nowadays as well as all forms of coins are vulnerable to *riba.* Thus it seems clear that the *Illah* of *Mutlaq uth Thamaniyyah* (the legal tender) is the most fitting reasoning of *riba* to cover today's transactions in conformity with the *Shariah*'s intents and purposes.

ii) The *Illah* of *riba* in items other than gold and silver.

With respect to the *Illah* of *riba* in the other four items (wheat, barley, dates and salt) there is also a difference of opinion amongst the *fuqaha* of the different schools of *fiqh.* The following are most important opinions demonstrated in this connection.

- The opinion which stipulates that the *Illah* of *riba* in the four commodities arose from their applicability to be exchanged by measure at weight. This was the view of the Hanafis, the Hanbalis and the Ja'faris. It was also accepted by the Zaydis. *riba,* according to them may run on all items which are tradeable by measure or weight regardless of any other characteristic.

- The opinion which stipulates that the *Illah* of *riba* in the four items stems from their edibility. This was mainly the view of Imam al Shafi' and was also reported as an opinion of Imam Ahmed (but not the common opinion of the *madhab*). According to this persuasion, all commodities which are edible are subject to *riba.*

- The argument which points that the *Illah* of *riba* in the four items is grounded in their nature as being necessary for subsistence and as being storable. This was the opinion of the Malikis who considered all items that sustain life and enjoy the characteristic of storability are subject to *riba.*

- There is also an unpopular view, developed by Rabia'h Ibn Abi Abdul Rahman and others who suggested that the *Illah* of *riba* in the six items is their subjectability to *Zakah*; thus, *riba* according to them only runs upon things which are susceptible to *Zakah.* (See al-Misri, 1977, p. 165).

From the foregoing opinions, however, it appears that none of them has suggested the satisfactory reasoning for *riba* concerning the commodities other than gold and silver. The one-sided explanation of the *Illah* as demonstrated by each is no longer considered adequate to satisfy the intention of the shariah which aims at eliminating *zulm* (injustice) from all forms of business transactions and at ensuring justice. It seems quite difficult, thus, to imagine that the exchange of one meter of cloth for two meters of its own counterpart, or the exchange of one litre of milk for one and a half litres of the same kind of milk were deemed lawful by the Prophet since they are not mentioned in the *Hadith* nor are they subject to one or another of the forementioned reasonings of *riba.*

Thus, the author is of the opinion that the four items which are mentioned in the *Hadith* are merely a sample which represent all commodities exchanged in the market. They were chosen for this purpose, because they were the most popular and tradeable commodities at that time.

For example, one cannot imagine that the rice would not be included if it had been the chief commodity rather than the wheat or the barley.

Accordingly, without hesitation, it can be said that all commodities exchanged in the market are subject to falling into *riba al Buyu* when failing to satisfy the forementioned conditions. In addition to the previous argument that 'legal tender' (*Mutlaq uth-Thamaniyyah*) is the reasoning of *riba* in currencies, the last opinion of generalizing the *Illah* of *riba* to all tradeable commodities successfully addresses today's transactions. They also conform with the lofty aims of the shariah which strictly prohibit any injustice which is inflicted in any unfair exchange or any other business practice. (see Wahbah (1977), Homoud (1982), and Chapra, (1985)).

3.3 *Riba* and interest

3.3.1 Conceptual Prelude

Following the previous discussion of *riba*, a pertinent question which is still to be answered is whether the bank interest is *riba* or not? To answer such a question, it is necessary at the outset to identify what 'interest' means? In one of its literal derivatives the word 'interest' means an advantage or benefit, in the sense that it refers to a charge of borrowed money. The word 'interest' stems from the mediaeval word '*intersse*' (the payment for damage or risk or default) as distinguished from the word '*usura*' (the payment for the use of money). (Knight, 1932). Looked at from the modern point of view interest covers many different concepts and definitions. However, it is generally defined as a payment for a loan (in money or in kind) over a period of time, measured by the difference between the amount repaid by the borrower and the principal received by him (Patinkin, 1968). Alternatively, as Abbass (1987) argued, interest can be defined as meaning any predetermined payment (per period of time) for loans (in money or in kind) as well as any predetermined reward (per period of time) for money capital.

Bearing in mind the definition of *riba* mentioned in the previous section as referring to an excess paid for time it appears that '*riba*' has the same meaning and importance as the word interest. Almost all Muslim *Ulama* are unanimous in their opinion that *riba* is interest. According to Mannan, (1986, p.162):

> "As a matter of fact, there is no difference between interest and usury or *riba*. Islam definitely prohibits all forms of interest whatever high-sounding and persuasive names we may give them".

Thus, if this is the case, then what makes some Muslim scholars suggest that the Islamic prohibition of *riba* does not cover contemporary bank interest?

Before going deeper into the arguments of those thinkers, two important remarks must be made at the outset of the discussions:

i) As stated earlier, in the introductory chapter, interest based banking was introduced into the Muslim world in the latter's state of decline. It was thus visualized as a manifestation of its dependency on the western world.

ii) Accordingly, the justification forwarded by those who advocated interest in the Muslim world mostly made use of the same arguments developed throughout history by those western thinkers who revolted against the prohibition of usury. Thus a brief history of the prohibition of usury in western thought and the development that led to its abandonment are necessary.

3.3.2 The Prohibition of Usury in Western Thought

Although the teachings of the Old Testament are usually visualized as being restricted to Judaism, it may be convenient to commence this review with their viewpoint of usury. An adequate justification for such an approach may be found in the two following facts:-

i) The significant role played by Jews in promoting usury throughout the financial history of the world in general and of Europe in particular. Thus, it seems necessary to know whether they were originally subject to any ban on usury or not?

ii) The revival of the Old Testament as a theological source of western culture as a result of the rise of Protestantism in Europe. This was a consequence of the reform movements which will be referred to later. Concerning this see the *Jewish influence on Christian reform movements* (Newman, 1966).

3.3.2.1 Usury in Judaism

According to Patinkin in the *International Encyclopaedia of Social Science* (Vol. 7, 1968, p.473),

> "the absolute prohibition of interest was an outstanding feature of ancient Hebrew economic legislation, as incorporated in the well known Biblical passages".

However, in examining the three Biblical passages which treat usury in the Old Testament, Jews will be condemned of "racial discrimination" since they enforced the prohibition of usury for Jews and allowed it in dealing with the non-Jews (*the gentiles*). They claimed that when a loan is made to a non-Jew or, in other words to him who is less known to the creditor, there would generally be a greater danger of loss of the principal, a risk which is regarded as warranting compensation. (Cleary, 1972).

Nevertheless, lending for usury was regarded by the Jews as one of the worst sins. Ezekiel classified it as equal to robbery and adultery:

> *"He hath given forth upon usury and hath taken increase; shall he then live? He shall not live, he hath done all these abominations; he shall surely die, his blood is upon him".*(Ezekiel, 18:13)

In addition, the attitude of the rabbis towards usury was very strict. They advocated that any advantage which could be created by loans was forbidden. In line with this, if a person had not been accustomed to greeting another person, he should not do so after getting a loan from him. Moreover, if a person has not been in the habit of teaching another the Torah before the loan, he should not do so afterwards (*The Jewish Encyclopedia*, Vol. 2, p.389). This limited prohibition however, was also violated by the Jews; it has been historically proven that in practice, Jews took usury in their dealings with each other. According to al-Hamshari (1973, p.34) the rate of interest they charged each other was one per cent per month. It is very well-known that lending one on a usury basis was the main source of income for the jewish money changers who were working at the temple. Through such a practice they brought about a serious level of corruption against which Christ revolted when he came to the Temple in order to drive all of them away.

It is stated in Matthew :

> *"Jesus went into the Temple, drove out the merchants and knocked over the tables of the money changers and the stalls of those selling doves. 'The scriptures say my Temple is a place of prayer,' he declared, 'but you have turned it into a den of thieves.'"*(Matthew, 21:12, 13).

3.3.2.2 Usury in the early sources of Christianity

Although no explicit words on the prohibition of usury exist in the New Testament, the following statements of Christ are to be considered:

> *"Give to those who ask, and don't turn away from those who want to borrow"* (Matthew, 5:42)
>
> *"Give what you have to anyone who asks you for it; and when things are taken away from you don't worry about getting them back"* (Luke, 6:30)
>
> *"And if you lend money only to those who can repay you, what good is that? Even the most wicked will lend to their own kind for full return. Love your enemies. Do good to them. Lend to them. And don't be concerned about the fact that they won't repay. Then your reward from heaven will be very great"* (Luke, 6:34,35).

It is obvious that the above teachings of the New Testament are not only encouraging people to lend freely, but also it asks them to sacrifice their loans and not to look for the repayment of the principal amounts which they have laid out.

In addition, the early fathers looked upon usury with severe disapproval. The conclusive standard for them was the Old Testament legislation and the general principles of the New Testament teachings (al Quasi, 1982).

During the patristic age, all lending for interest was forbidden to clerics by the Councils of Arles (314) and the Council of Aix (789) objected to making profit through usury; and by the 9th century, the ecclesiastics had begun to support the extending of the prohibition to the laity: bishops are to require all Christians to abstain from usury, and to punish the disobedients who are involved in it. (Hastings, 1922)

3.3.2.3 Usury in the mediaeval Christian view

The mediaeval world was generally characterized by the predominance of feudalism as a socio-political system which was firmly established in Europe (O'Brien, 1967) and the rise of the influence of the Catholic Church. The latter succeeded in uniting the religious and dogmatic codes to form the sole, universal, authoratitive organization of Christianity. Also, under the feudal system, the properties of the church had grown to such an extent that it had become one of the largest and most powerful feudalists (Tawney, 1946). This state of affairs clearly left the impact on the whole of mediaeval economic thought by facilitating the accommodation between the Canonist doctrine and the dramatic socio-political transitions.

The position of the Church on usury was given its most complete and authoritative exposition by Aquinas (1225-1274) as one of the great philosophers of the scholastics. His writing is representative of mediaeval thought. It put the teachings about usury on a foundation which was to support it for so many subsequent centuries (O'Brien, 1967) Western writers argue that Aquinas drew for his analysis of usury, on four sources of principles. These sources, according to them, were the philosophers of classical Greece and Rome; Greek and Roman civil law; the Jewish theologians of the Old Testament (a source shared by the

Christians); and the Gospels and the teachings of the early Christian Fathers (Taylor & Evans, 1987).

However, it can be argued that there is, in fact, another source which is often disregarded by Western writers. This was the Islamic thought which will be discused as one of the major sources as follows.

a) The influence of the theological teachings of both the Old and the New Testament and early Christians:-

It has already been stated that the 9th Century was marked by a strict prohibition of usury which applied to all Christians, and constituted a solid heritage for the scholastics in the mediaeval world. In line with this, Aquinas rejected the idea that the justification of interest is in the delay of payment. His rejection of the notion that interest is the price of time, was based on the theme that time belongs only to God and hence, nobody has the right to charge a price for it. (Shumpeter, 1954).

b) The Influence of the Greek philosophers:-

In classical times usury was strictly condemned by the two Greek philosophers; Plato and Aristotle. While the former's condemnation of usury was based on the class conflict it might create, the latter's was based on some deeper philosophical foundation. Aristotle distinguished between two kinds of wealth; one is the result of man producing artefacts from the raw materials, the other is in retail trade or finance. To him, the former is natural, necessary and honourable while the latter, which follows the introduction of a currency system in exchange, is unnatural and is therefore to be justly censored. Finance was seen by Aristotle as an evil art, and its most evil form was usury. This was because money, according to him, is only acting as a medium of exchange and cannot breed money (money does not breed money). Thus usury, which means the birth of money from money, is an unnatural use of it and contrary to the natural law. This is the basis of Aristotle's theory that money is only a medium of exchange (a theory which influenced Aquinas greatly); it is sterile and barren and cannot bear, and indeed ought not to bear interest (Taylor & Evans, 1987).

c) The Influence of the Roman Philosophers:-

Although in theory usury was prohibited in Roman civil law, in practice enforcement was inoperative due to universal evasion, and debtor protection was achieved by the imposition of legal maximum rates (O'Brien, 1967).

However, Roman philosophers were unanimous in their opposition to usury on moral grounds. Condemillionation of usury was strictly expressed by some philosophers like Cicero who considered the practice of usury as evil as the crime of murder. Seneca, however, argued for the allowance of usury within specific limits and under specific conditions, as a result of the Empire and the rise of trade and finance in it (Schumpeter, 1954). In his analysis of usury Aquinas was inspired by the Roman concepts of res fungibiles and res non fungibiles. The former refers to a commodity which cannot be used unless it is totally consumed (e.g. bread). The latter represents the case where use does not equate to total consumption. In other words, the commodity is not consumed after being used once (e.g. a house).

Money, according to Aquinas is a fungible which is 'legally' rather than 'physically' consumed. (Towney, 1946). The price of the loan of money as such, which of necessity is consumed in use, must be the return of its just equivalence which recognises the fact of economic duress on the borrower. (Taylor & Evans, 1987).

d) The influence of Islamic thought:-

Given the limited scope of this study, it is quite difficult to adequately establish clear evidence for the theory under consideration through this short outline. However, it may be sufficient to refer to the remarkable effort made by Mirakhor (1987) in his aforementioned work (*Muslim scholars and the History of Economics: A need for consideration*) in connection to this notion. In a highly balanced and fairly documented argument, the paper has provided many Western thinkers* with the unquestionable facts showing that the influence of Muslim scholars on Mediaeval Western thought is beyond any doubt.

Borrowing from Islamic thought was an undeniable feature of the writings of the scholastics in philosophy, ethics, the sciences and in the area of economics.

* Some of them are: Fischel (1933), Gauthier (1938), Durant (1950), Giullaum (1952), Crombie (1963), White (1971), Viner (1978).

More specifically, it is acknowledged that Aquines was intellectually influenced by Muslim scholars, particularly Ibn Rushd (d. 593/1198) who lived in Muslim Spain (*Andalus*) and known in the West as Averroes. In addition to his work in various branches of Islamic knowledge, Ibn Rushd also wrote what became the standard commentary on Aristotle's works and the standard style in subsequent literature in all fields of knowledge: this work includes three parts, the first of which is entitled "*al- Sharh al Asghar*" (the Lesser Explanation), a systematic and brief presentation of Aristotle's thought; second is called "*al-Sharh al Awsat*" (The middle explanation), in which Aristotle's writings were quoted according to subject matter and commented upon; the final part was "*al-Sharh al Kabar* (The Great Explanation), in which Aristotle's writings were quoted verbatim, paragraph by paragraph, discussed and commented upon (al Faruqi, 1986, p.310).

It must be borne in mind that Latin translation of Muslim manuscripts was undertaken in various places in Europe, and among the mediaeval western scholars there were many who were familiar with Arabic. Thus Ibn Rushd's work was very popular with the scholars of Paris university at which Aquinas studied Aristotle's ideas on economic matters. According to the explanation of Ibn Rush such ideas were expounded in the light of Islamic teachings with their emphasis on the theological nature of economic behaviour, justice, and the necessity for preservation of the Community (quoted by Mirakhor, *op.cit*, relying on Polanyi, 1957). Indeed, Ibn Rushd may be said to have anticipated the scholastic ideas on economics, mainly the concepts of just price and usury. It is reported that many economic ideas which have been visualized as compatible with the Scholastic's conceptions in the fields of money, credit, partnership, market and market forces and regulation, arguments against usury, theory of value, and other ideas find their origin in Ibn Rushd's work. The latter is found in his very well-known and widely used book on law and jurisprudence:*Bidayat al Mujtahid wa Nihayat al Muqtasid*, as well as two other books, namely *al Kharaj* (taxation) and *al Kasb al haram* (the prohibited earnings). (A'shor, 1973).

On the whole, Aquinas was said to have argued against usury. The concept of "*the just price*" which was mentioned above was extended to cover credit transactions through the call for the return of the equivalent money to the lender by the borrower.

To the misfortune of mediaeval western thought such a concept was, however, the window from which the winds of distortion blew. It was consciously devised as a means to justify interest or to evade the prohibition of usury. It is claimed that justice to the lender entails the introduction of amendments in the attitude of the church towards usury, an attitude which permitted the payment of interest along with the prohibition of usury. The modification covered events which a lender might experience. These are *damillionum emergens* (actual loss incurred); *lucrum cessans* (certain gain lost); *periculum sortis* (the risk of non-repayment). According to these principles, what is prohibited is any payment for a loan where there is no risk, no loss, no inconvenience and no loss of opportunity. (Tyler & Evans, 1987) However, the two concepts of the "*actual loss*" and the "*loss of opportunity*" were the main issues around which all the subsequent theological and canonist discussion was to turn. Given the first concept, the one essential condition was that real damage should have been occasioned; the Canonist theory demanded proof in each instance, that the necessity had in fact arisen, and that it had been causally connected with the conduct of the debtor. Frequently no sufficient proof could be adduced; and it was this that gave peculiar importance to the discussion of the other branch of the subject, i.e. *Incrum Cessans* (Ashley, 1936). While the first concept was accepted by Aquinas it is reported that he had indeed disapproved of any bargain to compensate for the lost profit; and for a time his authority was respected by most theologians (Ibid).

Nevertheless, it is argued that in the course of the fourteenth and fifteenth centuries, the great theologians and canonists, following the real thought of Aquinas, came to regard the contract for the recompense of the lucrum cessans as morally justifiable. Even some of the contemporaries of Aquinas among the Canonists held this opinion so that during the following century, the fourteenth, it could hardly be regarded as strictly prohibited by the Church; and in the fifteenth it was certainly generally accepted by the leading theologians (Ibid).

3.3.2.4 Usury after the middle ages

The early sixteenth century witnessed the revolt (known as the Reform Movement) against the power and influence of the Church under the leadership of Martin Luther (1483-1546), John Calvin (1509-1564), John Knox (1513-1572) and many others. Religiously this was a reform movement within Christianity which gave rise to Protestantism and substituted the authority of the Bible for that of the Roman Church. Politically, it was a struggle against the feudal system accompanying the dissolution of the Roman Empire. From the moral point of view, the Reform Movement contributed to the development of individualism through its emphasis on the autonomy and freedom of individual. The spirit of that age was expressed by Machiavelli's (1469-1527) precept: "*the end justifies the means*". This was accompanied by his explicit call for the separation between religion or morality and politics which represented the foundation stone of secularization.

On the whole, such dramatic developments represented a challenge to the Canon Law.

However, Anglican scholars, were reported to have continued condemilliona-tion of lending money for interest. Martin Luther, in this respect, was representative of a quite conservative view.

According to Ashley (1936 p.456-7),

> "Luther at first took up a far more intransigent attitude than the Catholic theologians themselves ... he abominated and vehemently attacked all forms of usury in which any payment was demanded from the deserving poor for the use of money. But from persons able to pay he would permit payment to be received in the two cases of rent-charge (*census, zins*) and interest, interpreted in their original and most narrow senses."

Calvin on the other hand held a more liberal view; he did not condemn all forms of usury; neither did he give it indiscriminate approval or countenance it as trade (*The Encyclopaedia of Religion and Ethics* Vol. 12, p.533). He laid down seven conditions for dealing in usury. The most important one was that usury was not to be demanded of people in need or distress. Other conditions were that poor brethren were to be considered, the welfare of the state was to be safeguarded, and the changed rate must not be excessive (Ibid).

What deserves to be noted here, however, is that interest was not accepted by the Canonist Reformers for the delay in repayment. The great Canonists of the late sixteenth and early seventeenth Century, did lay down that delay could be dispensed with, and they sought to strengthen their position by reference to the isolated expressions of the older scholastics (Ashley, 1936).

It is also worth mentioning that, in the course of the development of economic thought and practice, the sixteenth and the seventeenth centuries were known as the Mercantilist era. The latter has been characterized by the rise of money which began to be used on a large scale for commercial transactions and exchange began to replace barter. Accumulation of money and treasure became the national policy of the state and hence no effort was spared to accumulate precious metals (gold and silver) (Qurashi, 1967). Mercantilist thinkers (e.g. Petty and Locke) contributed a great deal to the controversy over usury. Generally, they advocated low rates of interest to encourage trade; they thus strongly supported the statutory fixation of low rate of interest (Ibid). Accordingly, the civil legislation which was developed in England in 1571 and in Germany in the same Century began to provide for moderate charges of interest. (*The Encyclopaedia of Religion and Ethics, op.cit*). Still more daring in accepting interest is the point of view of the Post-Reformation economists. Turgot (1727-1781); the Finance Minister of Louis the 16th and Bentham (1748-1832); the pioneer of the Utilitarians, had the effect of removing anti-usury laws from the statute-books of Western European Countries by the 1860s (Schumpeter, 1954) and (Taylor & Evans, 1987). The absence of such legislation was short-lived as experience of duress and injustice led to the reintroduction of new anti-usury laws by the end of the 19th Century. However, in the present day when the word usury is employed at all, it refers to a rate of interest which is regarded as iniquitous or illegal, while all other interest rates are legal. (Ibid). This means the anti-usury sentiment of the present day western thought is only confined to exorbitant rates of interest.

In modern economic thought, on the other hand, various theories including monetary and non-monetary have been developed to provide justification of interest. The money purchasing power, liquidity preference and the sterility of money theories were the main monetary arguments over the interest debate. The main non-monetary theories of interest were those which advocated profit, use of money, labour and the abstenance suffered in lending as justification for interest. A systematic investigation of these theories as well as many others is provided by Abbas (1987) in his outstanding thesis "*The rejection of interest and the advocacy of profit sharing*".

3.3.3 Some misgivings About the Islamic Prohibition of Interest

For more than fifty years bank interest has been a controversial issue among Muslims, although Muslim *Ulama* have cleared up the confusion over the matter as already stated in this chapter.

Despite the absence of the Islamic authority which could ensure the enforcement of Islamic shariah in the Muslim countries, some Muslims accept the prohibition of interest and do not deal in any interest-based transactions. However, others remain unconvinced and continue their dealing in interest arguing that the prohibition of *riba* does not apply to the bank interest as it is practiced nowadays.

For the dispute over such a state of affairs, there are unfortunately some Muslim *Ulama* and economists who express some misgivings about the prohibition of interest affected by the contemporary economic circumstances. A brief outline of the most popular justifications they suggest in order to legalize the bank interest is to be made as follows:

- The claim that only *riba* in sales is prohibited. This was misleadingly suggested by some Indian Muslim scholars who argued that the *Quran*ic text concerning the prohibition of *riba* is general and indistinct; thus, unlike *riba* in sales which has been identified by the *Sunnah*, the prohibition of *riba* does not apply to interest on loans.
- Others have expressed the view that it is the compound interest which is prohibited by Islam and not the simple interest. Originally this was the opinion of Sheikh Abdul Aziz Jawish (1908) who relied, in his theory, on the words "*doubling*" and "*redoubling*" appearing in verse 129 of *Surat al-Imarn* mentioned earlier.
- Some persons have also expressed the view that interest on loans for productive purposes was non-existent at the time of the Prophet and, therefore, interest on loans for productive purposes might be justified. This opinion

was initially ascribed to Professor Sanhuri who expressed his views in lectures given in Cairo between 1954 and 1959 and later adopted by others like Dawalibi (See Sanhuri, 1954).

- Similarly, some persons argue that the banning of interest would cover only the current accounts rather than investment accounts. This is suggested by al-Fanjari (1979) who has attempted to justify his opinion describing the relation between the bank and the depositors as being a *Mudaraba.*

- It has also been suggested that in an inflationary environment a system of indexing bank advances and deposits to a price index in order to restore the purchasing power of the money is justifiable (Naqvi, 1981, and others).

- Similarly, but less popular, some persons have also argued in favour of interest charges if they are used: a) by the government to induce savings; b) to finance trade; and c) as a form of punishment of debtors who have not fulfilled their obligations.

As might be expected all the above arguments have been discussed and rejected by the vast majority of Muslim *fuqaha* as well as economists. The unsoundness of these misgivings as well as others can explicitly be found in the discussion of the subject made by many including Homoud (1982) al Qusi (1982), Ilahi (1986), Khan (1985) and many others.

Of most far-reaching importance in this regard, however, is the position of the contemporary Muslim *Ulama*, an interest expressed in two authoritative documents. The first was the *fatwa* (formal legal opinion) issued by Muslim *Ulama* in the second conference of the Islamic Research Academy '*Majma' al Buhuth al Islamiyyah*' of al Azhar in 1965 at Cairo. The second was the report of The Council of Islamic Ideology (CII) in Pakistan namely, 'elimination of interest from the economy' issued in 1981. In this report it has been explicitly asserted that:

> "there is a complete anonymity among all Islamic schools of *fiqh* (*Madhahib*) that the term *riba* stands for interest in all its types and forms"(reprinted 1983. p.111).

Muslim *Ulama* of the *Majma al Buhuth* have also drawn up the following rules:-

- All forms of interest on loans are prohibited without exception and without any distinction between consumption loans and production loans, because both the *Quran* and the Prophetic sayings are strict and clear on the prohibition of interest and they do not make any exception to it.

- All interest is prohibited regardless of the rate or the amount.

- All bank operations which levy no interest (e.g. current accounts, payment by cheques) are permitted and charges for bank services are permitted too.

- All bank operations which have interest (e.g. deposit accounts, saving accounts) are prohibited.

What are the reasons then for this strict condemnation of *riba* in Islam? This question is to be answered in the following section.

3.4 The Rational of the Islamic Prohibition of Interest

3.4.1 Does the *Quran* Address the Issue?

It has often been stressed that the *Quran* does not explicitly spell out the wisdom behind the prohibition of *riba* (interest). However, when the previous verses covering *riba* are contemplatively examined it appears that the *Quran* clearly discloses the main reason behind the prohibition of *riba* as being the practice of *zulm*. The *Quran* says:

> *"... and if you repent (give up dealing in riba) then you shall have your capital funds; neither shall you make zulm nor shall zulm be made to you"* (2:279).

Indeed, while this verse has been overlooked in the Arabic writings of the subject, it is often mistranslated into English and hence its full meaning is not satisfactorily expressed. *Zulm* as defined in the introductory Chapter of this study has a far-reaching or a broad meaning. In this context it implies all spiritual, moral and socio-economic corruption which *riba* brings to society. To this end, the great emphasis, made by the *Quran*, on rejecting *zulm* will be fairly understandable. The word *zulm* and its derivatives have been mentioned 290 times in the *Quran*. 105 of which suggest a gloomy picture of misfortune and the miserable end of those who practice *zulm* (*Zalimeen*). One aspect of this is to lack Allah's love (3:140), forgiveness (4:168), guidance (3:86), and support (2:270); automatically, this will also lead to the absence of *falah* (6:21). Another important consequence of *zulm* is the destruction of its practitioners by Allah in their life time (18:59). More importantly, they will also be subject to a severe punishment in the hereafter (14:22). From the above discussion it can be concluded that the *Quran* has provided a major key to the rational of the prohibition of *riba*. It is simply the *zulm* which is: a) pointed out in the sense of condemnation b) by its very nature implies different aspects of human corruption c) another source of evidence of the misery and the severe punishment to which these who deal in *riba* should be subjected.

3.4.2 Contemporary Muslim Thought

It has already been stated that the majority of Muslim *Ulama* are of the opinion that the prohibition of *riba* is absolute and includes all types of interest known today. For this strict condemnation of interest, both earlier and contemporary Muslim *Ulama* have demonstrated different reasons based on the general objectives of the *Shariah* rather than focusing on the forementioned verse which refers to *zulm*. While the former had primarily focused on the moral dimension of the prohibition of *riba*, the latter has treated the subject in the light of the prominent socio-economic goals of Islam. Indeed, there are currently a significant number of analytical contributions on the wisdom and economic significance of the abolition of *riba* from the society. al-Mawdudi (1961), perhaps was the pioneer amongst contemporary Muslim scholars to cover the undesirable effects of *riba* on the society from a comprehensive point of view including spiritual, moral, social, political and economic aspects. The concluson of his analysis is that no nation allows dealings in *riba* without running the risk of creating the worst psychological traits (e.g. selfishness, greed and avidity for matter) as well as the confrontation between the rich and the poor people within the society. The accumulation of such consequences will cause the economic and socio-political disruption of the society leading to its destruction.

In addition, of those who contributed valuable presentations to the economic aspect of the subject are Abdou (1977), Wahba (1977), Zarqa (1982) Siddiq (1983) Rushdi (1983) and Chapra (1985). In the analysis of the economic rational of the Islamic prohibition of interest, this study has benefited a great deal from these presentations.

On the other hand, since the rationale of the Islamic rejection of interest is, by definition, challenging the western arguments advocating interest, it may be useful, at the outset of this analysis, to refer to some recent western opinions on the subject.

Currently, many western economists are admittedly voicing increasing concern about the gravity of socio-economic problems which arise from the institution of interest according to Rodney Wilson (1988):

> "Indeed, many of the economic problems of the Western World may stem from an excessive reliance on *riba* finance, and the narrow and unhealthy obsessions which it seems to bring" (p.17)

More worrying and perhaps the most astonishing is the view that interest in some of its aspects is causing extremely serious problems that could choke the world economy to such an extent that it would virtually lead to the end of the western civilization of the present day. Tim Congdon (1988) has expressed this in the introduction of his recent book, *The Debt Threat - the dangers of high interest rates for the world economy.* Referring to this problem he stressed:

> "a problem which began six or seven years ago, is still deteriorating and, unless something is done, will soon cause many books to be written on the impending disintegration of the international financial system, the imminent breakdown of Western Civilization and countless other horrors." (p.1.)

Now, to bring the strands of the argument together, the reasons for the prohibition of interest on the economic side can be discussed as follows:

3.4.2.1 Debt finance for investment

This type of debt finance primarily involves business loans. The latter are frequently granted by creditors (banks or other financial intermediaries) to debtors (businessmen or business firms) as short term finance for stockholding and to alleviate temporary shortages of funds. With this method of finance, the creditor is naturally most concerned about the safe return of his principal money jointly with the interest stipulated. This is, of course, irrespective of the outcome or the record of the debtor's project in which the borrowed money is to be invested.

Clearly, the implications of such a relationship between both the creditor and the debtor will have its negative impact on the overall performance of the economy:-

- While the interests of the creditor push him to maximize the interest rate on his advances, the debtor's do the contrary. This of course, will adversely affect the spirit of cooperation among the members of the society and will hinder the integration of capital and labour. Hence, the relationship between both of them will work out on conflict and enmity rather than harmony and cooperation.

- Although the lender takes into consideration the creditworthiness of the borrower, he does not have to undertake an evaluation of the latter's project. Naturally, when a two-sided evaluation of projects is carried out by both the supplier of funds and the entrepreneur, as is the case in interest-free economy, a more efficient performance of the economy is expected.

- Debt financing often goes to the most creditworthy parties who are usually the large-scale businesses, and not to the small businesses which do not possess sound collateral but have the most promising potential. Small businesses however, may sometimes contribute more effectively to the growth of the economy in terms of national product per unit of financing. This clearly hampers the optimum allocation of resources.

- It is already understood that in interest-based transactions the lender does not share in the risk of the business finance. He transfers the entire risk of business to the entrepreneur and assures himself of a predetermined rate of return whatever the net outcome of the borrower's business is. Thus, when a loss is incurred, the entrepreneur is obliged to bear it and pay the interest out of his own assets. From the individual as well as the social viewpoint this is very unfortunate; it is unjust and results in maldistribution of income and wealth in society. It is clear that the new wealth flowing to the creditor from loss-incurring business does not result from new wealth created by the deployment of the funds he advanced, as losses mean that the financed operations failed to create new wealth. Once again, this redistribution of existing wealth in favour of tenders is obviously inequitable.

- In the light of the above, wealth owners who choose to lend and wait steadily grow richer over time whereas wealth owners who choose to expose their wealth and abilities to the risks of productive enterprise have no such guarantee. Naturally, this encourages wealth owners to act as lenders and rentiers rather than expose their wealth to entrepreneurial risks, either directly by investing them in owner-enterprises or indirectly by offering them as collateral against loans obtained for business. This eventually deprives the society of possible gains arising from investing in productive enterprises.

- Under the contractual obligation made on the borrower to repay the principal along with interest, he may find himself obliged to employ the borrowed funds as profitably as he can. This means that prospects of higher profits will be the economic criterion which should channel investible funds to a specific project regardless of any other social priorities. In such a case ensuring an efficient allocation of resources as a goal of fiscal and monetary policy will no longer be possible.

- Entrepreneurs often transfer the burden of interest to the consumers as a proportion of the prices of goods and services. This means that under interest-based systems all the members of the society pay an indirect tax to the lenders.

- The interest-based economies are usually subject to a severe economic crisis known as trade cycle. In fact, the rate of interest is normally determined by the demand for and supply of the loanable money. Also, at the initial stage of development of an economy the rate of interest relatively remains at a lower level. Due to low cost of production, the consumption of goods rises and hence entrepreneurs get maximum profit margin. Being satisfied with realized profit and in anticipation of more in future, entrepreneurs tend to undertake more production of goods. This gives rise to demand for more capital, and lenders thus seize the opportunity and begin to increase the rate of interest. The higher the rate of interest the higher the marginal cost of production. The result will be a higher selling price which often goes beyond the ability of most purchasers. This smashes the expectations and the hopes of the entrepreneurs of sati sfactory profits. This brings a disaster to the economy; with the rise of the m arginal cost of production, the selling price frequently increases and the purchasing power of money goes down and down marking the existance of inflation. In such circumstances some entrepreneurs tend to pile up the stock of the manufactured commodities in a base state of monopoly; millions of tons of finished products remain unsold for want of buyers while millions do not find goods for satisfying their wants due to their low purchasing ability. In this difficult situation some entrepreneurs will be forced to curtail further the production, causing unemployment all over the country. It is this gloomy picture in which interest is one of the most important destabilising factors in capitalist economies which made Milton Friedman (1982) pose the question:

"What accounts for this unprecedentedly erratic behaviour of the US economy ?"

He responds by saying:

> "The answer that leaps to mind is the correspondingly erratic behaviour of interest rate"(p.4)

The instability of the interest-based economies historically resulted in the great crash in 1929 which recently has been repeated in October 1987 as the international financial markets collapsed. While the real and precise consequencs of the latter on the international economy have not been written yet, much has been written about the tragedy for the international economy. For the United States alone, for example, 9000 banks closed their doors between 1930 and 1933, while industrial production fell by 40 percent and unemployment increased to almost 25 percent of the labour force. (Congdom, 1988, p.3)

3.4.2.2 Consumer debt

In the consumption field two different types of loans can be distinguished:

i) Loans made to needy consumers who do not have the money to cover the very basic necessities of their life e.g. food or medicine.

ii) Loans made to those consumers who would like to purchase consumer dur - ables such as cars or houses.

Because it is not easy for needy consumers to get bank loans, they usually turn to traditional money lenders whose actual function is nothing but exploitation of poor people. Their practices in all contemporary interest-oriented societies make no room for doubt about this.

In a capitalist society like Britain for example, no recent issue has captured the imagination of economists, entrepreneurs and the public in quite the same way as the question of high interest rates. Some frightening realities about the difficult situation in which British needy people, who face deepening debt, live have been revealed in a very recent report made by Stephen Cook (*The Guardian*, 31 May 1989). The report includes several stories of poor families, who are

> "confronted by mounting bills and eager money-lenders (and) are turning to high-interest loans, only to be sucked into a spiral of crippling repayments."

The report begins with the story of a mother who takes her children into the kitchen and hides under the table when the debt collector from Provident Personal Credit arrives on the doorstep of her council house. She says:

> "When I am on my own I feel frightened."

She and her husband are both 20, and fairly typical of the growing number of people who arrive at the local Citizens' Advice Bureau after slipping steadily into debt, at exorbitant rates of interest to meet their ordinary living expenses. Her family income is £116 a week of which £45 goes on rent and fuel. Debt repayments, which began when their cooker went wrong and they bought a new one, total £53 a week. The mother said,

> "If we paid everything each week we wouldn't be fed, so we have to miss one of them to feed this pair",

indicating her four year old son and two year old daughter. The Provident loan which prompts the collector's visits was for £300, with £149.70 interest charges over a year. This annual interest rate of nearly 50 per cent is three times what a bank would charge, but it is not easy for poor people like this family to get bank loans or credit cards. Instead they go to the dozens of small finance companies which operate in low-wage areas. The most horrifying and shocking fact provided by the report however is that, "some loans come at annual percentage rate of 200 per cent; APRs (annual percentage rates) of 1.000 percent are not unknown".

In a different place of the report this was further confirmed by Mr Peter Barnett, assistant chief trading standards officer of Staffordshire County Council who said,

"We hear of cases where the interest rate runs into thousands of percent . You could restrict interest rates, but then the lenders wouldn't lend, and what do you say to the woman who needs the money for food. People are running up huge amounts of debt at all levels of society nowadays".

Under this system of *riba*-dealings, it is not only the inequality or the injustice which can be considered as a consequence of such a situation. It must be admitted that with such levels of greed and immorality of the money-lenders, as well as the harrassment they cause to debtors, it is the humanity and the dignity of man which has clearly been transgressed.

Hence, this sort of consumer debt is extremely distressing and a major source of suffering, hardship and misery for the poor of the society.

The second case of consumer financing for the purchase of consumer durables may mainly cover two cases. The first is installment purchases of luxury goods by wealthy people. In this case credit consumption may encourage unnecessary purchases which are only prestige-oriented or which do not make any difference in the 'real' well-being of the individual or his family. The second is financing purchases of necessary durable consumer goods like freezers, cars, and houses for low- and medium-income households. This case can be regarded as the same as that of the first major sort of consumer debt discussed before, except that the debt payment with *riba* itself imposes significant hardship. Some real evidence for this is provided by the aformentioned report; one suffering debtor says,

"I got the loan to buy a car, but I wouldn't go to a loan company again, not even to buy a pair of shoes. I wouldn't wish what's happened to us on my worst enemy."

Another source of evidence comes from another report by Angela Johnson (*The Guardian*, 31 May 1989), which covers the crisis of the housing finance in Britain in the light of the rise of interest rate. According to this report,

"Increases in interest rate from 9 to 14 percent over the past year have forced many people to realise the equity on their property and taken out secured loans to pay

> off mortgage arrears and consumer debts. But crippling rates on the new loan have resulted in a record number of families losing their homes after failing to meet repayment. Many more face eviction by finance companies and building societies."

In one of the cases quoted by the report one woman says,

> "we could not find the mortgage money because we had other consumer debts which just kept mounting up after my husband was off work sick for about three months."

Evictions and reposessions are already soaring as home-buyers fail to meet mortgage costs. Last year, according to the report, almost 20,000 homes were reposessed by building societies - an increase of 900 percent since 1979. The number of people who fail to meet their payments for six to 12 months has soared from 8,420 in 1979 to over 50,000 in April 1989. In a response to such a gloomy situation Tin Mendolia, a debt counsellor at the Cambridge Citizens' Advice Bureau, says,

> "One woman even considered aborting her child because she could not afford to give up her job. Some haven't started feeling the pinch because they have been on fixed payments which change annually when building societies re-adjust their figures for next year. It's going to get really tough."

When interest is seen as the main factor of such a tragedy, what then will the appropriate remedy be except that of its abolition as suggested by Islam.

3.4.2.3 Public Debt

Public debt is divided into two categories; national debt and international debt. Government borrowings on these two levels will be briefly discussed as follows:-

1) National debt: Under this category government borrowings take different forms covering different purposes: Perhaps the most familiar and important form is the marketable debt which can be divided into:

a) Short term borrowing (Treasury bills) which arises when receipts of tax revenue and the expenditure of the government are not perfectly synchronised. To meet the imbalance, the government sells treasury bills to the lenders. It must be noted that this fund is mainly raised to finance current consumption (current spending) which is assumed to be financed by taxation. Resorting to borrowing to cover current expenditure means that the 'public savings' (the balance of the current account) is negative, a sign which indicates a bad performance for the economy. According to the World Bank's report (1988) on *World development*:

> "Borrowing to build assets is acceptable ... while borrowing to fund consumption is not (p.108)."

To meet the interest charges of this borrowing the government has no option but taxing people in different ways and forms of taxation. In this context, two important points can be noted. The first is that:

> the raising of taxes to meet interest payments represents a transfer of income, and to the extent that a large proportion of government debt is held by (or on behalf of) high income groups, this may be considered as a regressive redistribution, i.e. one which accentuates inequalities of income" (Maile, 1982, p.245).

The second is when taxing lenders, in the above mentioned process of covering interest, this means that the government collects taxes (to meet interest payments) from the same group of people to whom it pays interest!. Therefore, the cost of administering tax to the extent that it is connected to interest payment is to be regarded as an unjustifiable waste of the society's wealth.

b) Long term government securities which are issued to finance capital spending, either to initiate basic infrastructure such as roads, water, electric power and telecommunications or to undertake investments in the public sector industries. Financing such projects through interest-bearing loans suffers from the same irrationality which attends investment in the private sector. Although the forementioned report of the World Bank argues that capital spending will generate returns in the future, it raises important points in relation to this return:

Firstly, the definition of capital spending as spending on tangible assets introduces a bias towards 'hard' sectors, such as infrastructure, and away from social sectors, for which physical capital investment is a small share of total spending.

Secondly borrowing may need to be limited not only for stabilization but also because public investment may not always yield long-term returns as high as the cost of debt service. Low returns on investment of borrowed capital have contributed significantly to the current international debt crisis. Thus, since the return on the borrowed capital may not cover the cost of debt service, the rest of due money must be paid from the assets of the society. This means that the latter will eventually carry the burden of possible losses. Hence guaranteeing a positive return to the supplier of money capital is clearly unjust.

2) International debt: As stated in the introductory chapter, the contemporary world economy is facing extremely serious problems. With the massive International debt, inflation, corruption and many dangerous problems which threaten the very fabric of life of many nations this economy became a question mark.

However, the now boiling over International debt crisis remains to be central amongst these problems. The massive debt of developing countries, which most economists agree is unpayable as it stands, could bring vast social, economic and political upheaval, adding to the world's misery. It has soared to over US \$ 1,000 billion today while the ability to serve and repay has not risen. Commensurately, in 1988 external debt of countries with Brazil and Mexico reached to US \$ 114.60 million and US \$ 96.70 million respectively (Taylor, 1989, p.17). The debt/export ratio for all third world countries steadily increased from 82 per cent in 1980 to 169 per cent in 1986, while their debt service ratio increased over the same period from 13 per cent to 25 per cent. As is often the case these averages disguise significant deviations, notably in Latin America with the largest debtors (as studied above) and in Africa with the poorest countries. In Latin America, debt/export ratio increased from 183 per cent in 1980 to 349 per cent in 1986 and debt service ratio from 34 per cent to 50 per cent (all figures from the IMF, *Annual Report*, 1987, Table 10 p.30). In Subsahara Africa, the debt burden has been doubled since 1982, and now represents 54 per cent of GDP, or almost 400 per cent of 1986 export earnings (*The Financial Times*, 30th November, 1987).

In response to such a situation western and international banks, which are awash with funds are eagerly looking for every opportunity to find the suitable markets to lend to. According to Taylor (1989),

> "Bankers vigourously lobby, even bribe, third world officials to take out loans. One former Latin American finance Minister is quoted as saying: (I remember how the bankers tried to corner me at conferences to offer me loans. If you are trying to balance your budget, it's terribly tempting to borrow more money instead of raising taxes)." (p.14)

Under the tragedy of the external debt of Latin America, many Latin Americans today are deeply concerned about their future:

"How can we provide for the necessary economic growth for the future and pay for the external debt at the same time?... What kind of world will our children inherit?" (Ibid. p. 16)

As they contemplate their future, one thing has become increasingly alarming; per capita debt has exceeded percapita income in some countries in their continent. In 1988 while the former in Nicaragua, for instance amounted to US $ 1,850 the latter was found to be only US $ 560 (Ibid). In his examination of the causes of the international debt explosion, Tim Congdon (1988), has pointed out:

"In practice most debt has an interest element and it is this element which is almost invariably the trouble maker" (p.3).

He further stressed,

"The root of the trouble is that interest is charged not only on the loan principal but on the accumulating interest which is annexed to it over time. In due course, particularly in a world where nominal interest rates are 10 per cent or more, interest on the interest exceeds interest on the principal. At first sight, this may seem improbable, not to say bizarre. But let us examine the consequences of 10 per cent interest rates more carefully. A little dexterity with a pocket calculator shows that a loan doubles after 7.27 years of 10 per cent interest rates." (p.9)

Lastly, from the previous discussion it is obvious that interest has a dangerous effect in disrupting the moral and socio-economic structure of the society. Islam by nature would never suggest a remedy for a specific problem which will eventually be worse than the disease as is the case in the man-made codes (The IMF proposals to the developing countries must be noted here). Thus, make no mistake about it, Islam has strictly laid down the unquestionable solution which is the elimination of the "*root*" of all the previous problems as well as many others, namely *interest.*

If this is the case, then what is the Islamic alternative to interest; and will it be applicable and viable in the very sophisticated contemporary financial scene? The answer to these questions will be dealt with in the following chapter.

Chapter IV

Islamic Banking: Theoretical and Practical Development

4.1 Introduction

The purpose of this chapter is to introduce the reader to the theoretical and practical development the of the Islamic banking system as an alternative to the prevailing interest-based system. This will be done through two major sections divided into several subsections. The first section will focus on the theoretical aspects of profit sharing as an underlying model of Islamic banking and the methods of finance which it may provide. Different aspects of the contemporary Islamic banking movement will be dealt with in Section 2 under the major heading: Islamic Banking: Emergence and Practice. In addition to the origin, and the motives for the establishment of Islamic banks as well as their operations, three important issues will be discussed in this section. The first will be the levels on which Islamic banking is practiced in the world including the individual Islamic banks and the experience of both Pakistan and Iran in establishing Islamic banking. The second is the role of Islamic banks in the socio-economic development of their countries. The third and final issue will be the major obstacles and difficulties facing Islamic banks.

4.2 Theoretical Background

4.2.1 Profit Sharing in Islam as an Underlying Model of Islamic Banking

The prohibition of interest in Islam requires that if Muslims want to introduce Islamic economic principles, banking and financial practices they have to be organized on a basis other than interest. Extensive studies have been made on this subject which suggests that the principle of profit sharing offers the best alternative to interest in Islam. Simply explained, profit sharing is a system for reorganising banking practices and procedures on the basis of the principles of profit/loss sharing in consensus with the Islamic legal concepts of *Musharaka* and *Mudaraba.*

It has been suggested by many Muslim economists that the name of the proposed system must be "profit- sharing" instead of "profit-and-loss-sharing". Bearing the loss is understandable as far as the rules and the procedures of the system are concerned, because they explicitly provide for a sharing of the losses accruing to the capital according to an agreed ratio. In other words, it is quite clear that neither the entrepreneur nor the other suppliers of capital actually 'share' the loss accruing to any particular suppliers of capital. This is true of *Musharaka*, in which all partners are suppliers of capital as well as of *Mudaraba*, in which a particular partner may be supplying no capital at all, as will be explained later.

The profit sharing system regards losses as an erosion of equity (i.e. decrease in capital) and profit as a joint result of and reward for capital and enterprise. In contrast to interest, profit is not predetermined and fixed but is uncertain and variable, and may even be negative. Profits are either the reward for investing capital or for entrepreneurial flair in undertaking risky investments (see Manan (1986) and Qurashi (1967)). Karsten (1982) has formulated interest and profit as they are set forth in Islamic literature as follows.

Let P0 denote the amount lent to the borrower in period T0, and P1 the agreed amount of capital that has to be returned in t1. If P1>P0 then the difference between P1 and P0 is the addtional amount (interest), r, or *riba* in the Islamic sense. i.e.

$$r = P1 - P0$$

Profits and losses (PL) involve an element of uncertainty. Each partner in a *Mudaraba* or *Musharaka* business is sharing an agreed prportion of the expected difference between total revenues, R, and total cost, C. Expected profits for a participant in a joint venture are thus:

$$E(R - C) = E(PL)$$

where E denotes expected value.

On the other hand profit-sharing is not alien to western economic thinking. As an alternative to the familiar wage system it has recently much been discussed both at the theoretical level (notably by Weitzman (1983, 1984, 1985a, b, 1987) and Mead (1986a, b.) and in policy debate (in the U.K., centred on recent government intervention to encourage profit-related pay). (Cable and Wilson, 1988)

In one of his arguments on the subject, Martin Weitzman (1985a) has suggested that the profit-sharing system is superior to traditional capitalism because,

> "The profit-sharing system has the potential to automatically counteract contraction ary or inflationary shocks - while maintaining the advantages of decentralized decision-making. And these desirable properties are robustly preserved throughout a variety of economic environments. At the very least, widespread profit-sharing can be a valuable adjunct to traditional monetary and fiscal policies" (p.42)

In another paper Weitzman (1985b) also has concluded that:

> "A profit sharing economy has some natural tendencies toward sustained, noninflationary, market-oriented full employment. A profit sharing economy can avoid dreaded Keynesian unemployment, even when conducting an anti-inflationary monetarist policy" (p.952)

Addressing the question of profit-sharing as an alternative to the wage system Weitzman (1985a) issues a "friendly challenge" for his critics saying,

> "I challenge anyone to cook up an empirical real world scenario, with a reasonable number of specifications, where a profit-sharing system does not deliver significantly greater social welfare than a wage system" (p.45).

Such a confident view of Weitzman was confirmed by a comparable study carried out by Cable and Wilson (1988) on the effect on productivity of profit-sharing in the engineering industry in both the U.K. and West Germany. According to the study, estimates for a sample of firms in the West German engineering industry indicate that productivity differentials of 20-30 percent in favour of firms practicing profit-sharing. This compares with estimates of only 3-8 per cent for a similar sample of British engineering firms. It must be emphasised, thus, that the model underlying Islamic banking, is not also alien to Western economic practice. In the broader international context, some features of the proposed system have already been in existence in the banking systems of leading western countries. For instance, the German banks have from the very begining been engaged in equity financing on a considerable scale and have aptly been termed as *all-purpose* banks. (For details about this type of banks see Hanson, 1987).

In Japan before the Second World War, commercial banks actively participated in under-writing shares and in the post-war period also the under-writing business continues to be strongly influenced by them. In France the *Banques d'Affaires*, which represent an important part of the banking system, undertake investment financing on participation bases. In recent years, commercial banks in a number of western countries have increasingly adopted new financing techniques such as leasing, hire-purchase and the exercise of "convertibility options" which shift loans into equity (see Kindleberge, 1974, 1983, 1984). As far as the position of the U.K. is concerned, it is noteworthy that in recent years private saving institutions such as pension funds, investment institutions and insurance companies have assumed a role in equity and other long-term financing which closely approximates the role of commercial banks in Germany. Institutions of this type are exercising a powerful influence on corporate decisions in the U.K. and a number of other industrial countries. (See Revell (1972), White (1984) and Llewellyn (1985))

4.2.2 Methods of Finance Under the Profit-Sharing System

Keeping in view the Islamic prohibition of interest Muslim jurists have elucidated principally two forms of business arrangement based on the philosophy of profit-sharing, namely *Mudaraba* and *Musharaka*. Both have undergone many modifications to cope with the developed requirements of the modern financial world. With the growth of the Islamic financial movement a wide range of ancient and new Islamic financial instruments, including *Mudaraba, ijara, qard hasan* as well as many others have been developed to replace interest-based instruments. An endeavour will be made here to point out the principles and procedures of the most important modes of financing and investment adopted by contemporary Islamic banks and financial institutions.

4.2.2.1 *Mudaraba* (Equity Sharing)

1) The meaning of *Mudaraba*:

Muslim jurists define *Mudaraba* as an arrangement or business contract between two parties wherein one party provides capital (The owner of the capital *Rubb-ul-mal*) and the other contributes the (entrepreneurial) labour (the agent manager - *Mudarib*) provided that the realized profit is shared between them in a ratio agreed in advance. (Ibn Rushd, 1981-Reprinted) In Islamic *Fiqh* several terms are used to define this contract; *qirad*, *muqarada*, and *Mudaraba* are interchangeably used to identify the same contract. The difference appears to have been perpetuated by the *Madhahib* (Schools of *Fiqh*), each within its main geographical area. While the Malikis and the Shafiis in Arabia adopted the term *qirad* and *muqarada* the Hanafis in Iraq adhered to the term *Mudaraba* (Udovitch, 1970).

Mudaraba was not only known in pre-Islamic and Mediaeval Arabia, but it also happened to be practiced in the Mediaeval West. In the Western World (e.g. in the Italian law) it came to be known as *Commenda* (Udovitch, 1970).

Although not mentioned in the *Quran*, the practice of the pre-Islamic *Mudaraba* was endorsed by the Prophet and became an Islamically acceptable technique of business finance. (Qurashi, 1984).

2) The subject matter of *Mudaraba*:

In discussing the subject matter of *Mudaraba* Muslim juristis distinguished between three kinds of *Mudaraba*; a) money *Mudaraba* b) commodity *Mudaraba* and c) productive *Mudaraba*. (Haque, 1981).

For the majority of Muslim jurists, *Mudaraba* can be formed with any legal tender. Goods were not considered admissible for the *Mudaraba* contract unless the goods are first sold and the resulting revenue is considered as the base capital of *Mudaraba*.

The *Fuqaha* have generally recommended *Mudaraba* for exploiting the gains for price differentials that exist in different parts of the world. Thus many of them have rejected the formation of a *Mudaraba* contract that required the manufacturing of goods and sharing the production, or what is called productive *Mudaraba* (Khan, 1985). But as Udovitch (1970) pointed out, this can be avoided by employing a simple device involving sale of the goods in question, and sharing in the profits afterwards. This type of *Mudaraba* is approved by the later jurists of the Hanafi School. Maliki and Shafi'i jurists, two other major schools of *fiqh*, have rejected any such kind of contract. Islamic economists have considered the Hanifis argument in the subject as the basis for productive or industrial *Mudaraba* (see Siddiqi, 1985).

3) Conditions of *Mudaraba*:

The essential conditions and features of *Mudaraba*, have been elaborated by both early and contemporary Muslim scholars (see Abu Saud (1980), Abdul Qadir (n.d.) and Qurashi 1984)), can be summarized as:

- The liability of *Rabb-ul-mal* is restricted to his capital.
- The *Mudarib* can also be a *Rabb-ul-mal* in a bilateral *Mudaraba*.
- The loss is entirely borne by the *Rabb-ul mal*, whereas the *Mudarib* loses only his labour and effort unless it is proved without doubt that this loss was due to his wilful acts of negligence.
- The *Mudarib* must have absolute freedom in managing and controlling the business.
- The *Mudaraba* has to function within the parameters of the contract; if the *Mudarib* violates one or more of them, the contract will be nullified.
- All business expenses are a charge on *Mudaraba* income.
- The basis of profit-sharing has to be defined without any pre-emptive right to any party.
- *Mudaraba* business can encompass any field of economic activity provided it does not conflict with the *Shariah*.

As far as the application of this method of finance in Islamic banks is concerned, *Mudaraba* arrangement integrates assets and liabilities according to specific conditions. Under this technique, depositors enter into a contract with the bank to share the profits accruing to the bank's business. The bank on its asset side, enters into another contract with an agent-entrepreneur who is searching for investable funds and who agrees to carry out the venture in accordance with *Mudaraba* conditions as mentioned above. The bank's earnings from all its activities are pooled and are then shared with its depositors and shareholders according to the terms of their contract.

In line with the above, finance under the *Mudaraba* technique may be provided to artisans, professional traders and other entrepreneurs with profitable and feasi ble projects which they are unable to undertake due solely to lack of capital.

4.2.2.2 *Musharaka* (*al-Sharikah* - Partnership financing)

1) The meaning and forms of *Musharaka*:

Muslim jurists unanimously agree in defining the *Musharaka*, or *al-Sharikah*, as a contract according to which two or more parties agree to share in an enterprise with a contribution either in the form of capital or labour. The resulting profit or loss is to be distributed among the partners (al Khayyat, 1983). The Hanafi and Maliki schools of *Fiqh* divide the *Sharikah* into two broad categories: *Sharikat al milk* (proprietory partnership) and *Sharikat al-'aqd* (contractual or commercial partnership). Proprietory partnership occurs when two or more people are partners in the posession of property. It may arise from voluntary actions such as buying a property jointly or involuntary factors such as inheritance. Hence, proprietory partnership is of insignificant importance for commercial and business transactions. Thus, it seems appropriate to overlook this kind of partnership and concentrate on commercial partnerships which represent the most important and essential concept of partnership as a financing technique. Commercial partnership is usually divided according to the subject of partnership (i.e., capital or labour) into three kinds, namely; *Sharikat Amwal* (partnership based on money), *Sharikat A'mal* (partnership based on labour), and *Sharikat al-Wujuh* (partnership based on reputation) (al Khayyat, 1983) and (al-Khafif, 1962). The commercial or contractual partnership can also be divided into two types, called *inan* and *mufawada* according to the equality and inequality of the partners in the following matters.

i) The amount of each partner's investment and private possessions: In the *mufawada* partnership each partner has to own the same amount of investment in the partnership. In addition all the members of the partnership must have an equal amount of private possessions besides their equal shares in the partnership. These two conditions are not applied to the *inan* partnership where each partner holds a certain number of shares in the partnership's capital regardless of the amount of his private possessions.

ii) The level of authority and the right of disposal in their joint capital: Since the *mufawada* partnership is fundamentally based on mutual surety and mutual agency, the authority of partners in running the business is unlimited, each partner is authorised to represent the others in any delegation or business. For the authority of partners in the *inan* partnership which is considered as an agency contract, Muslim scholars differentiate between two types of *inan* joint ventures namely the specified and the general partnership (El Ashker, 1987). While the specified *inan* partnership imposes limitations on the partners authority in running the business no limitations are imposed by the general *inan* partnership.

2) Profit-sharing in the *Musharaka*:

In partnership in general, profit should be distributed on a ratio known in advance which may not necessarily be in proportion to the respective capital contributions. A partner or a group of partners may receive an extra portion of profit in compensation for extra work involved in the partnership and not any social privilege (Ulovitch, 1970). However, if any loss due to adverse market conditions or any other factors beyond the control of the party who is in charge of the management of the partnership occurs, it will be shared strictly in proportion to the respective capital contributions (El Ashker, 1987). If, however, the loss occurs due to wilful acts of negligence or breach of contract on the part of a party of the partnership, the entire loss must be borne by that party. Following the equality of each partner's share in the *mufawada* partnership it is stipulated that profit distributed to partners must also be equal. In an *inan* partnership, in contrast, profit may vary according to the agreed-upon proportions.

3) The Financial liability in partnership:

In the *mufawada* joint venture which is best translated as unlimited-authority partnership, the financial liability of partners is unlimited; partners are responsible for the partnership liability towards third parties, including their private possessions. In the *inan* joint venture which is best translated as limited-authority partnership due to the fact that the relationship between partners is based on the principles of agency without surety, the financial liability is determined as follows (El Ashker, 1987, p.74).

- The financial liability of each partner is confined to the level of limitations as defined in the contract
- The partner should not go beyond his delegated authority without consulting the other partners with regard to the limit of credit given or received. Violating this prerequisite will extend his liability to third parties to his private possessions.
- Dealing on credit must be restricted to the partnership capital
- When applying the above, the liability of each partner will be limited to his share of the partnership capital; otherwise, each will be responsible individually for the extra liability created from his own transaction.

4) The type of business in partnership:

In a *mufawada* partnership all partners have to carry out the same sort of business and they cannot independently diversify their business. In contrast, partners in the *inan* partnership are permitted to practice any sort of private business and to share in more than one partnership (al-Khayyat, 1983).

5) Similarity of religion:

For the *mufawada* partnership it is stipulated by Muslim jurists that Muslims are not allowed to form this sort of partnership with non-Muslims because the latter may be involved in prohibited business activities (e.g. dealing at interest). However, Imam Abu Yusuf, a great thinker of the Hanafi *Madhab* considers that a Muslim is allowed to share with non-Muslims in this particular form of partnership. He may have thought that the Muslim partner could lay down sufficient conditions in the contract to ensure that the other party would be involved only in Islamically permitted activities. Such an argument was in fact the basis for allowing a Muslim to be involved with a non-Muslim in an *inan* partnership.

In the modern application of *Musharaka*, Islamic banks may finance local and import/export business as well as fixed and working capital requirements of industries on a *Musharaka* basis. The banks may also apply decreasing partnership terms for the financing of industrial and agricultural projects. In this case the equity element provided by the bank as a part of its financing will be bought over a period by the partner until such time as the *Musharaka* is liquidated.

4.2.2.3 The *Murabaha* (cost-plus or mark-up trade financing)

Murabaha is a method for financing the purchase of commodities, tools or machinery or any other items on the basis of cost plus an agreed profit margin. *Murabaha* financing is widely used as one of the most important activities of Islamic banks nowadays. Under the *Murabaha* arrangement, a customer may request the bank to purchase particular items on his behalf. The sale price of an item will be its total cost plus an agreed amount of profit.

It is worth mentioning at this stage, that this form of business arrangement was first suggested by Homoud in his Ph.D. thesis in 1976 under the name of *Bai' al-Murabaha li al Amir bi al-Shirah* (the *Murabaha* sale to the purchase-orderer). Since that date, the subject has become the focus of many studies in Islamic banking in theory and practice. For conducting the *Murabaha* operation, Muslim scholars have developed the following conditions that must be laid down in the agreement.

- The specifications of the commodity required by the client must be identified clearly and precisely in the agreement and if the bank fails to meet them completely, the client has the right to reject the commodity.

- If the commodity conforms exactly to the specifications drawn up in the agreement, the bank can compel the client to accept it, although, the compulsion to abide by promises involved in *Murabaha* is one of the most debatable and problematic issues in this matter.

- The price of the items required (including the profit of the bank) must be defined in the agreement.

- Payment by the client may be made either on immediate or on a deferred basis. It may also be either in a lump sum or installments, as agreed.

- Once the sale price is fixed it cannot be altered whether the client makes the payment earlier or later than stipulated.

- The bank is liable for any damage, harm or loss occurring to the commodity. It is also responsible for any hidden defect found in the items.

- The bank may require the client to offer adequate security against breach of the terms of the agreement.

To further ensure the safety of its operations the bank must also satisfy itself in advance about the experience, skill, integrity and business conditions and prospects of the client. It also studies the nature of the items to be purchased, their marketability and price trends etc. The client may purchase the items for his own use or for further sale. This technique of finance has now become very popular in Islamic business mainly in international trade and import finance. With the growing importance of this sort of finance many *fatwa* have been issued to advocate its permissibility and legitimacy. The following *fatwas* are perhaps the most popular ones.

- The *fatwa* of the First Conference of Islamic banking held in Dubai in May 1979.

- The *fatwa* of the Second Conference of Islamic banking held in Kuwait in March 1983.

- The *fatwa* of al-Baraka Symposium held in Holy Medina in Saudi Arabia in July 1983.

Although the above *fatawa* and many others have tried to legitimize *Murabaha* as a permissible arrangement of Islamic business, several Muslim scholars have demonstrated their rejection of it from different aspects; see al Ashqar (1984), al

Amin (1983), Shalabi (1987), Umar (1987), and al-Jundi (1986). Points raised against *Murabaha* financing can be summarized as follows:-

- Since the client approaches the bank in fact for finance and not a genuine commodity, *Murabaha* is deemed a new means of earning interest.
- None of the earlier Islamic jurists have made statements about this arrangement so as to legitimize it.
- *Murabaha* is one type of illegitimate sales in Islamic jurisprudence called *Bai al-A 'yyina.*
- It is a two-in-one transaction, which is prohibited in Islam.
- In this sort of business the banks do not own the items which they are selling and this is prohibited in Islamic *Shariah.*
- The practice of most of the Islamic banks that the promise to buy is binding for the client is problematic and questionable from the *Shariah* point of view.
- In the *Murabaha* arrangement the bank does not face considerable risks and the profit is almost guaranteed to it just as it is to one who charges interest which is in contradiction of the Islamic *Shariah.*

The above objections, however, have been discussed and rejected by some muslim scholars who are in charge of the *Fatwa* in some Islamic banks. al-Qaradawi (1986) for instance wrote a book called *The application of Murabaha trade as practiced by Islamic banks.* He tried to refute all the arguments made against *Murabaha* and attempted to prove that such a transaction is permissible in Islam.

Although it is not the aim of this thesis to discuss the matter in more depth it can be said that in all circumstances Islamic banks must be careful in practicing *Murabaha* deals because they cannot cover up interest by giving it another name (Sakr, 1983)

In addition to *Mudaraba*, *Musharaka* and *Murabaha* financing which constitute by themselves the major forms of the Islamic alternative t the *riba* financing, a number of financing arrangements within the general framework of Islamic shariah have been suggested by a number of Muslim scholars. A brief summary of these arrangements is to be continued here.

4.2.2.4 *Bai Muajjal* (Deferred sale)

It is a trade deal in which the bank agrees to receive the price of a commodity from its client at a future date in lump sum or installments. The agreed price in such a transaction can be the same as the spot price, or higher or lower than the spot price. Since the *Murabaha* financing implies *Bai Muajjal* as explained earlier, they are often, but incorrectly referred to as meaning the same thing. This was demonstrated by the (CII Report) mentioned earlier and adopted by others (see, al-Hamar, 1988). *Bai Muajjal* need not have any reference to the profit margin that the bank may earn. The only element that makes it different from a normal sale is the deferred payment. In the sense that it is the same as *Murabaha* Muslim scholars have stressed correctly that it should not be widely used as a chief mode of finance.

According to Chapra (1985),

> "The danger will however, always remain that the *muajjal* and the *Murabaha* forms of sales may deteriorate into purely financing arrangements with the agreed profit margin being no more than a camouflage of interest" p.171.

In line with this, the (CII Report) demonstrated that:

> "It would not be advisable to use it widely or indiscriminately in view of the danger attached to it of opening a back-door of dealing on the basis of interest" (p.118-9).

4.2.2.5 *Bai Salam* (purchase with deferred delivery)

Bai Salam is a trade transaction in which the buyer pays, in advance, the seller the full agreed price of an item which is to be delivered at a specified future date. Clearly, this sort of business transaction is to be confined to commodities of which the quality and the quantity are known at the time of the deal's agreement (al-Abadi, 1982). Because of this characteristic, this future delivery method is particularly suited for agricultural financing. The bank enters into an agreement with the farmer for the future purchase of the latter's agricultural products and makes the payments when the contract is concluded. The assets of the farmer could be used as a collateral for the payment as a guarantee against fraud or negligence. If any financial losses are incurred in the operation however, they would have to be fully borne by the financing bank (Khan & Mirakhor, 1985)

4.2.2.6 *Ijara* (leasing)

Ijara is an arrangement under which the Islamic bank leases equipment, a building or another facility to a client for a specific period of time against an agreed rental fee. The bank would retain ownership of the asset but the client would have the exclusive right to the use of it. At the end of the agreed period the asset reverts to the bank. The rentals would be sufficient to amortise not only the capital outlay but also to yield, after taking into account the 'salvage' value of the asset, an adequate amount of profit for the bank (Chapra, 1985).

4.2.2.7 *Ijara wa-iqtina* (hire-purchase)

Hire purchase is a contract under which the Islamic bank finances equipment, building or other facilities for the client against an agreed rental together with the undertaking from the client to make additional payments in a *Mudaraba* account with the bank. These are reinvested for the client's benefit and will eventually permit the client to purchase the equipment, building or facility.

4.2.2.8 *al-Qard al-Hasan* (Benevolent loans)

al-Qard al-Hasan is a loan transaction in which the client undertakes to repay the principal at a stipulated future time but on which no interest is charged. Levy of a modest service charge on such a loan is permissible but it has to be based on the actual cost of administrating such a loan (Ahmad, 1985). As an interest-free loan *al-Qard al-Hasan* is more a benevolent undertaking. A repayment schedule suited to the economic circumstances of the borrower would be instituted. Islamic banks finance such loans mainly from current accounts and interest-free savings account funds. They could also be financed through special funds usually deposited for this purpose as will be explained later.

In addition to the above major financing and investment devices Islamic banks sometimes adopt other techniques to perform their operations. In Pakistan for example, it has been suggested that banks may provide finance through other methods like investment auctioning, normal rates of return (the normal rate of return in each industry would be payable to the bank on the amount provided by it as profit) and time multiple counter-loans (where the client gets a loan of say, £3,000 for one year if he deposits with the bank £1,000 for three years). However, such forms of financing have stimulated a great deal of controversy and doubts have been expressed about their acceptability within the framework of *Shariah*. Nevertheless, with the growth of the Islamic finance movement, the development of new financial instruments remains a continuous process. Hence there are still many earlier arrangements of Islamic business which can be developed to serve the expansion of modern Islamic finance. Among these are the contracts of the *Joa'alah*, the *Musaqah*, the *Muzara'ha*, the *Istisnaa'* and many others.

4.3 Islamic Banking: Emergence and Practice

4.3.1 The Origin and Development of Islamic Banks

As Muslim scholars began seriously to explore the features of the Islamic banking based on profit sharing, there was a general feeling of doubt about the possibility of formulating a convenient theoretical model, let alone a practicing institution. Such a lack of confidence stemmed from the success of the well-established interest-based institutions and their influence in the modern financial world. However, with the increase in knowledge about the subject as a result of organized research on a global scale, attitudes towards the subject began to change.

The earliest experiments in applying Islamic banking began on a modest scale in the early sixties as mentioned in the introductory chapter of this thesis. Movement towards the establishment of Islamic banks gained momentum in the seventies. Apart from in Pakistan and Iran, there are now more than fifty Islamic banking financial institutions in the rest of the world (shown in Appendix A), many of which are operating at an international level. Much of this has been done through private initiatives, but they have inspired some interest at the state level as well.

Several Muslim countries have undertaken steps towards the introduction of Islamic banking on an evolutionary basis. The establishment of Islamic banks in a number of these counries has been facilitated by special enactments and suitable changes in banking legislations. This includes Dubai, Jordan, Egypt, Sudan, Kuwait, and Bahrain. Special but more comprehensive legislation has been introduced in Malaysia, Turkey, and United Arab Emirates to facilitate Islamic financial institutions, side by side with the traditional interest-based legislation. Thus, it should be mentioned that changes in banking legislation effected in these countries to facilitate the working of Islamic financial institutions are not intended to confer any undue advantage on these banks vis-a-vis the traditional financial institutions. They are in fact designed to remove some of the handicaps from which Islamic financial institutions suffer in conducting their operations in an economy where interest based transactions dominate the sense. Iran and Pakistan as mentioned earlier have made official commitments to replace conventional banking completely by Islamic banking, although, the Iranian experience comes within a comprehensive Islamic economic framework.

4.3.2 Three Levels of Conducting Islamic Banking in the World

In the light of the above, one can distinguish between three levels of the application of Islamic banking in the context of the application of the Islamic economic system as a whole. These are:

i) The experiment of establishing a large variety of private financial Islamic institutions including banks. They can be described as individual Islamic banks and financial institutions.

ii) The Islamization of the banking system in Pakistan as a partial application of the Islamic economic system.

iii) The Islamization of the banking system in Iran as a part of a comprehensive process of introducing Islamic principles in all spheres of economic activity in a particularly exciting experiment. Each of these cases is to be briefly referred to in the following summary.

4.3.2.1 The individual Islamic banks and financial institutions

By individual Islamic financial institutions is meant those which owe their foundation mostly to private initiatives as stated above. Under this category, there are several Islamic financial institutions which are at present functioning in various parts of both the Muslim and non-Muslim worlds. They can be classed into three major categories. The first category is the form of Islamic Commercial banks which include among others, the Kuwait Finance House, the Faisal Islamic Bank of Egypt and the Jordan Islamic Bank for Finance and Investment which were the first three leading banks in 1987, as will be shown later.

The second category, is the Islamic Investment Holding Companies which have either a national or international mandate. This includes among others Dar al mal al-Islami (Geneva), the Islamic Banking System International Holding (Luxembourg), The Bahrain Islamic Investment Bank (Manama) and the collapsed Islamic Investment House (Amman). Although such institutions were established to conduct financing and investment operations, they are practically carrying out a variety of banking practices on a competitive basis with the first category. Both the first and the second categories are therefore functioning as all-purpose banks mentioned earlier.

The third category is the Islamic Investment Companies which dominated the Islamic financial movement in Egypt. A discussion of their rise and collapse will be referred to later in this chapter.

In addition to these three categories there is the Islamic Development Bank which was mentioned in the introductory chapter. Although the bank was set up by the Muslim governments (the members of the OIC) It is an individual institution which has had no influence in the introduction of Islamic banking in the banking sectors of these countries.

With the success and the growth of Islamic banks the need for an institution to perform some of the duties of a central Islamic bank was arisen. However, monetary authorities in Muslim countries have not allowed the establishment of any Islamic Institution which might cover any of the functions of Central banks. Under this situation, and as an alternative, the International Association of Islamic Banks (IAIB) was established in Cairo in 1977 as an advisory institution. Basically, the Association has been set up to provide the technical assistance and expertise necessary for the establishment and development of Islamic banks; promoting the activities of Islamic banks and fostering their growth, creating cooperation among Islamic banks in their operations and exchange of expertise; carrying out training and research projects in the field of Islamic banking. The membership of the Associaton is accessible to all individual Islamic banks and financial institutions. The Association has been recognized by the Central banks and monetary authorities of the Muslim countries and its status is also accepted by most major internaitonal institutions.

As for the extent to which the Association has succeeded in achieving its objectives, it has not realised the goals hoped for when first established. Perhaps for unjustifiable reasons not all Islamic banks are members of it. Its role in helping coordination and cooperation between Islamic banks and the exchange of expertise between them is still insignificant.

4.3.2.2 Islamic banking in Pakistan

Although Iran and Pakistan share many factors in their commitment to the Islamization of their banking, there are however, differences in their approach in pursuing their objectives. Pakistan was created in the name of Islam in 1947. The need for ordering economic life according to Islamic teachings was publicly voiced as early as the first year of the country's independence. However, the first serious initiative towards the elimination of interest came only when the deceased president of Pakistan General Zia-Ul-Haq specifically asked the Council of Islamic Ideology (CII) on September 1977 to prepare the blue-print of an interest-free banking system. The Council in turn, has produced an important report on the elimination of interest which was a result of a combined effort of economists, bankers and jurists.

Beginning in January 1981, interest-free counters were opened in all 6,600 branches of the five nationalized banks. Following a gradual schedule, the process of eliminating interest entirely from the banking system was claimed to have been completed in July 1985 (the different phases of the process are detailed in Atiyyah, 1986).

Generally speaking, the process was planned to be completed in two main phases. In the first phase Islamic banking was introduced partially side by side with interest-based banking. In the second phase it was asserted firstly that interest based banking had been eliminated and secondly that non-interest based banking had been instituted (Khan, 1987).

Although it is not the objective of this study to assess fully the performance of Pakistan's experiment in Islamic banking, it may be convenient to refer to some recent studies which covered the subject. Of special interest in this respect is the IMF Study (1987) carried out by Zubair Iqbal and Abbas Mirakhor on Islamic banking in both the Islamic Republic of Iran and Pakistan. As of the experience of the latter the study indicated that PLS deposits were not fully utilized under the non-interest based modes of financing. It revealed that PLS investments accounted for about 13 per cent of total bank credit and investments at the end of 1984. Over 80 per cent of such investments were, however, short term and were undertaken on the basis of markup and markdown methods of financing. Equity participation and *Musharaka* accounted for less than 15 per cent of the total. This is due in part to the lack of an appropriate institutional and legal infrastructure and experienced and trained staff needed to evaluate the projects requiring the participation by the banks (Iqbal, and Mirakhor, 1987).

Such a result was further confirmed by a leading Islamic economist in Pakistan, Dr. Fahim Khan (1987) who stressed that:

> "Around 85 per cent of the operations on the asset side of the banks are carried on mark-up based financing. As has been mentioned, mark-up has been introduced in a way not different from interest. Then 85 per cent of the operations on the asset side, therefore still remain unconverted in their spirit. They stand converted in letters." (p.13)

Furthermore, and more recently, another leading and very well-known Islamic economist Prof. Khurshed Ahmad has pointed out in a lecture given in a seminar held in Loughborough in July 26, 1988, that the application of the Islamic banking system in Pakistan is hindered by the prevalent standards of morality in the society. He stressed that the uninspiring socio-economic conditions of the present day Muslim Societies, coupled with the moral degeneration, have removed the opportunity for the success of the new system. A serious application of Islamic banking or any aspect of the Islamic system thus requires a radical and complete transformation, he emphasised. To him such a transformation cannot be realized merely through taking some cosmetic measures in a few sectors of the society or the economy. It requires a tangible improvement in the quality of the Muslim as a person and a reform of all systems (educational, economic, political and many others) which constitute the infrastructure of the Muslim society.

4.3.2.3 Islamic banking in Iran

Bearing in mind the dilemma which the Pakistani banking system is experiencing, it is perhaps convenient to begin this review of Iran's banking system with the latter's Islamic socio-cultural reorganization as explained by Shireen T. Hunter (1988) in the following passage:

> "Since the establishment of the Islamic government, Iran has undergone a profound and extensive social and cultural transformation. Iran's judicial system is now based on the *Shariah* and its prosecutor general is a cleric. At the Ministry of Justice, religious judges preside with lay judges in order to ensure the compatability of all decisions with the *Shariah*. The educational system has been even more affected. Khomaini and his followers believe that in order to create an Islamic society and government, the Iranians must be purged of un-Islamic influences and turned into true Islamic men and women. Thus since the revolution, school books have been rewritten, Iran's history has been reinterpreted, and great attention has been paid to religious instruction and the teaching of Arabic. The universities have been heavily purged, and since 1980 a seven-member Council for Cultural Revolution has been set up and has become the decision-making body of Iran's higher education system. Students wanting to go to universities are systematically and thoroughly screened and are accepted on the basis of their attitudes towards the Islamic revolution and their knowledge of Islamic history and precepts. In addition, radio and television programming has changed and the discussion of religious matters has acquired high priority ... The film making industry has flourished, but again with emphasis on revolutionary and Islamic themes ... Cultural revolution has also meant the denigration of Iran's pre-Islamic heritage and its representatives ... The government has also imposed a strict Islamic moral code including the obligatory Islamic dress for women. Popular groups have been organized to ensure strict adherence to the Islamic code of conduct." (p.269-70).

Within the above framework of transformation the process of Islamizing the banking system in Iran has gone through distinct phases since the success of the Revolution. In the first phase (1979-1982), the banking system was nationalized, restructured, and reorganized in order to remove the weakness of the inherited system (Iqbal and Mirakhor, 1987). The second phase began in 1982 and lasted until 1986. In this phase, the Parliament approved comprehensive legislation in August, 1983, to eliminate interest from the banking system and to implement a clearly conceptualized model of Islamic banking. The third and current phase, which began in 1986, promises a role for the banking system different from that in the earlier phases, although still within the framework of the law of *Riba*-free banking (Mirakhor, 1988). The 1985/86 data provided by the Central Bank shows that long and medium term finance accounted for 41.1 per cent of the total finance conducted in the banking system. This is in addition to 11.4 per cent extended by banks to the population on the basis of *al-Qard al-Hasan.* (Calculated from the Central Bank's data provided in Mirakhor, 1988). With such records the banking system in Iran is assumed to participate in pursuing the objectives of the economy as defined by the Constitution of the Islamic Republic.

The banking system was used as an instrument of restructuring the economy away from services and consumption toward production in four ways (Mirakhor, 1988). First, credit to the service sector which constituted some 55 percent of the GDP was drastically reduced to halt its further expansion in the short-run and curtail its size in the medium-term (Iqbal and Mirakhor, 1987). This policy went into effect during the second phase and has continued ever since. Second, bank credit was directed towards encouraging the growth of the agriculture sector. Several modes of Islamic finance were designed to help farmers improve and expand productions. Coupled with substantial government subsidies for seed, fertilizer, machinery, and crop insurance, the credit policy of the banking system has helped revive the agricultural sector.

This policy was initiated during the first phase and strengthened in the later phases. Third, Islamic banking was used to create incentives for the development of a cooperative sector spanning agriculture, industry and trade. Cooperatives were given priority in credit allocation and in direct investment as well as in *Musharaka* financing by the banking sector. This policy received a great impetus in the third phase. As a vehicle for income redistribution, the banking system has been used to provide interest-free loans (*Qard Hasan*), to build low-income housing, to provide financing for handicrafts and small businesses as well as co-operatives, without stringent collateral requirements. The banking system has also financed government expenditures and deficits, with a view to the distributional impact. The pattern of consumption and production has been affected by the banking system, not only through reduction of credit to the service sector, but also through curtailment of credit to the production of luxury goods and commodities with a large import content, while at the same time credit for the production of necessities and intermediate goods has expanded. It is clear that with a reduction of oil revenue from 27 percent of the GDP in 1977/78 to only

4 percent in 1986/87 the banking system has been a major source of finance for achieving many of the social and economic goals of the Islamic Revolution (Mirakhor, 1988). On the whole, all signs indicate that the Iranian experience in Islamic banking is a very special one which is vitally important to study.There are many lessons which can benefit other developing countries and assist the progress of the Islamic finance movement worldwide.

4.3.3 The Establishment of the Islamic Bank

The establishment of Islamic banks in the contemporary world was initially faced by the legal question of whether it would be in accordance with the fundamental principles of the different forms of Islamic partnership as prescribed by the *Shariah* or in line with the existing regulatory system of partnership and companies in most Muslim countries.

In principle, Muslim *fuqaha* and economists argue that the Islamic bank can be established on the principles of the *inan* partnership (based on capital) (Siddiqi, 1983). Under this form of business, as generally defined by the *fuqaha*, two or more persons participate in an enterprise with a fixed amount of capital agreeing that they will work jointly and share in the profit or loss proportionately.

However, most contemporary Muslim scholars, influenced by the well - established legal system which governs companies in the modern world, agree that the Islamic bank should be established under the rules of this system, mainly those of the public limited companies, with some modifications. Within this context, a compromise between the rules of both the *inan* partnership and the public limited company was specifically initiated. This was in order for the former to meet the requirements of the sophisticated financial world of today, and for the latter to conform to the *Shariah* and not to violate any of its rules.

It must be noted however, that most* of the currently operating Islamic banks are not legally registered as banks but as financial institutions that have been incorporated as limited companies empowered to transact the business of investment, trust, or finance. (Hassan, 1988). Their shareholdings are varied: while some, like Dar-al Mal al-Islami (DMI) and the al-Baraka International

* Some of course, have been formed purely as banks such as the Faisal Islamic Bank of Egypt.

Bank, are privately held companies, others, like the Jordan Islamic Bank and the Kuwait Finance House, are publicly held companies. Among the publicly held companies there are some which have shares held by their national government agencies and others which have shares held by foreign government agencies as well as international financial institutions (Hassan, 1988).

Since the public limited company is the most common form according to which Islamic banks have presently been established, it is convenient to highlight some of its basic conditions as adapted to satisfy the *Shariah*.

- Under the regulation of such a company the capital of the bank is divided into equal shares and each partner (shareholder) subscribes to a number of shares. Hence each shareholder would become the owner of the bank, proportionately with the value of his shares.

- While it is normally agreed by Muslim scholars that the shares of the bank are transferable others argue that this ability to transfer will be confined to Muslims only (El-Gammal, 1980). In the *Shariah* there seems however to be little evidence for this view and, practically, it is already stated that in some Islamic banks a number of shares are held by non-Muslim parties.

- The liability of the shareholders is limited to the value of the shares they own in the bank's capital. Although this was agreed upon by most of Muslim scholars (see al-Khayyat, 1983), Siddiqi (1983) has suggested that the liability of each shareholder of the bank should not be limited to the extent of his share capital but should in principle be unlimited. Receiving and advancing loans by the bank is the only justification proposed by Siddiqi in support of his opinion, although this is not beyond dispute from the *Shariah* standpoint.

- There are modifications in the way of raising funds for the bank. Not all shares issued by the public limited company are permitted in Islam. While some such as ordinary shares are allowed, others such as bonds which involve a fixed rate of interest and some sorts of preference shares are prohibited.

- Modifications also occur in the management of the bank as well as in the methods and techniques of accountancy (Shahata, 1985).

- More important, is that the Islamic bank must establish a *Shariah* control authority which is responsible for ensuring the conformity of the bank operations with the rules of the *Shariah*. In the existing Islamic banks this authority varies from being represented in a Supervisory Board to merely having a *Shariah* adviser.

4.3.4 Motives Behind the Establishment of Islamic Banks

When reviewing the development of the contemporary Islamic finance movement the main factors which motivated the establishment of Islamic banks can be distinguished as follows:

- The Islamic revival which in a sense came as a result of the failure of the alien ideas of capitalist and communist ideologies which dominated the socio-political development in the Muslim world for decades. Under this state of affairs, the growing religious feeling among the Muslim masses had widely stimulated a stand against dealing in *riba* since it is prohibited in Islam. Hence, this encouraged Muslims to look seriously for a substitute way of investing their money in a legitimate '*halal*' way.

- As stated in the introductory chapter, another important factor was the crisis of the contemporary international economy and the economic depression that has affected the third world economies (including the Muslim world). This has inspired many experts and economists in these countries to talk about the necessity of a new economic system as an alternative to the prevailing one.

- Some of the existing governments of the Muslim World have leniently allowed the introduction of Islamic banking. Such attitudes however are not independent of political factors. It is undoubtedly aimed at convincing the people that these governments are concerned with Islam, since the importance of Islam and Islamic symbols in public life has been intensified in the Muslim world mainly after the success of the Iranian Islamic revolution in 1979.

- The so-called petro-dollar phenomenon which arose in the Arab oil-rich states after 1973. Since this phenomenon occurred at the same time as the Islamic revival, it helped the emergence of the Islamic finance movement at different levels. It stimulated the establishment of the early and the leading banks in these rich countries (e.g. the establishment of Dubai Islamic Bank and the Kuwait Finance House). It also raised the substantial funds allocated for the establishment of Islamic banks in other countries (e.g. Jordan and Egypt) through the remittances of their workers in the oil-rich states.

4.3.5 The Goals of Islamic Banks

Individual Islamic banks have in general set for themselves the following objectives (see Islamic Banks' laws and Articles of Association).

- The elimination of interest from all forms of banking and investment transactions since it is prohibited in Islam.
- Fulfilling society's needs for adequate and satisfactory banking eervices and facilities in conformity with Islamic *Shariah.*
- Supplying Muslim Investors with adequate finance for undertaking investment projects in accordance with the *Shariah* principles.
- Participating in the achievement of socio-economic development of society through all forms of business trade and investment that are not prohibited by Islam.
- In line with the above, they aim to contribute to the achievement of social security through the collection and the payment of *Zakah*, the provision of benevolent loans (*al-Qard al-Hasan*) and any other *halal* activities which emphasise the spirit of cooperation among the members of the society.
- In addition, Islamic banks also aim to promote economic integration amongst Muslim countries through harnessing the resources available in the richer Muslim countries and redeploying them in others suffering from shortages of capital but having adequate human potential.

After more than a decade of substantial growth of the modern Islamic banking movement a great necessity has arisen for the review of the above objectives.

However, in this stage of the study the main focus will be on the role of Islamic banks in the achievement of socio-economic development which is to be examined after the following section.

4.3.6 The Operations of Islamic Banks

It is already understood that *Islamic* banking as a term, primarily refers to banking that is *permissible* under Islam. In their operation, thus, Islamic banks and financial institutions have adopted the operating financial instruments of conventional banks where they are not incompatible with the Islamic *Shariah*. They should, however, have their own methods and instruments which is appropriate for their own and distinctive nature as being interest-free institutions. In a signal summary Atiyyah (1986) has divided the operations of Islamic banks in terms of their permissibility into four major categories as follows:

1) Financial instruments (assets and liabilities) and lending facilities that are used by the conventional banks and are not allowed by Islamic *Shariah*. These are not practiced by Islamic banks. They include:

- Interest - bearing certificates (i.e. bonds, certificate of deposits, and zero coupon bonds)
- Loans, overdrafts and other facilities
- Interest-bearing documentary credit
- Discounting bills of exchange
- Factoring
- Financial and personal loans
- Interbank loans

2) Techniques and financial instruments (assets and liabilities) which are debatable from the *Shariah* viewpoint. These are used by conventional banks and partially accepted by some Islamic banks. These can be summarized as:

- Collecting fees on letters of guarantee

- Bonus on current and savings account
- Swap and forward dealings
- Options
- Financial leasing
- Financing of working capital
- Indexation
- Compensation for delay
- Discounting on early payments

3) Techniques and financial instruments (assets and liabilities) utilized by conventional banks but which do not clash with Islamic *Shariah.* These are also practiced by Islamic banks but differ in application. This category can be divided into three groups:

i) Services:-

- Opening current accounts
- Issuance of personal cheques
- Issuance of travellers cheques
- Issuance of credit cards
- Opening, advice on and confirmation of documentary credits
- Purchase and sale of gold and silver (spot)
- Acceptance and collection of bills of exchange and promissory notes
- Remittances and drafts
- Acceptances, guarantees and other obligations
- Issuance of deposit certificates denominated in gold and silver

- Collection of dividend and other services
- Safe-keeping of articles of value, locked boxes, wills and many other items
- Renting of safe-deposit boxes
- Investment advisory services
- Letters of introduction
- Trust and property management
- Consulting and legal counselling
- Preparation of feasibility studies

ii) Financial Assets:-

- Leasing
- Investment auctioning
- Sovereign lending
- Project financing
- Transaction loans
- Consumer finance
- Subordinated loans
- Financing of working capital

iii) Direct Investments:-

- Equity participation in ongoing companies
- Promotion of new enterprises and joint ventures
- Venture capital
- Sale and purchase of foreign currency

- Real estate
- Trading in commodities (other than precious metals)
- Purchases and sale of precious metals (other than gold and silver) on a spot and forward basis

4) Techniques and financial instruments (assets and liabilities) that have been innovated by Islamic banks and financial institutions. Among others, these include:

- Investment deposits both specified and unspecified
- *Mudaraba*
- *Musharaka*
- *Murabaha*
- Hire purchase
- Deferred sale (*Bai Muajal*)
- Forward purchase (*Bai Salam*)
- Benevolent or interest free loans (*Qard Hasan*)
- *Muzara'h*
- *Musaqah*
- *Istisnaa'*
- Islamic swap

4.3.7 The Role of Islamic Banks in Socio-Economic Development

The question which might be raised here is, is it possible for Islamic banks which operate in a non-Islamic economy to contribute to the socio-economic development of their countries? Perhaps this is the most controversial question which has faced the Islamic banking movement since the early days of its rise.

This controversy has been unfortunately sharpened but not resolved by those writers who emphasise on every occasion, the developmental aspect of Islamic banks without being conscious of what factors may or may not help the evolution of this aspect of Islamic banking.

Thus, to answer the question under consideration, the first step which needs to be made is to examine the operational and environmental conditions and circumstances under which a conventional development bank operates and hence to examine their existence or non-existence in the case of an Islamic bank:

- It is common in the literature that development banks should be predominantly, if not wholly financed by governments. This of course implies the existence of the government guarantee of funds invested in these institutions (Drake, 1980). Contrary to this, Islamic banks are privately owned and consequently receive no subsidies from the government. Moreover Islamic banks are even deprived of the ordinary financial facilities usually extended to conventional commercial banks and lending institutions.

- Following on from the above, in addition to the support of local governments, development banks mainly in the developing countries often obtain different forms of financial aid from foreign public and international sources. For many reasons, Islamic banks do not receive any. The suggested but uncertain exception, however is the case of the Islamic Development Bank (IDB) which may provide Islamic banks with finance but on the basis of profitsharing rather than loans or grants as is the case with development banks.

- Development banks, for more effective performance, used to restrict their activities only to serve a specific economic sector. Thus, it is common that development banks existed under various sub-categories such as industrial development banks, agricultural development banks, small industry development corporations and the like. Such a specializaton is, of course, a crucial factor in reducing the operating cost of the bank. It would help in saving the effort needed for collecting informations about sources and uses of funds, for focusing on problems related to forms and methods of financing projects in different sectors, for the analysis of the impact of goals and policies of development plans in various economic sectors. Conversely, Islamic banks, are designed to perform both banking and development functions for all sections of the economy. Islamic banks, thus, are known as all-purpose banks as stated earlier. This without doubt, will increase the operational cost of the bank since it tends to serve more than one field of development financing as well as banking services within all the limitations which exist in an un-Islamic (interest-based) economy.

- Although development banks may be cautious in selecting their clients, they are eventually and normally liable to no loss since they strictly impose heavy guarantees on their borrowers to meet any expected defaults. Islamic banks in contrast, are liable to loss since they operate on the profit sharing basis. Thus Islamic bankers are expected to be more cautious than conventional bankers in selecting their clients more wisely and carefully. However, this is not an excuse for them to act as *risk-aversers* instead of being *risk-takers*. Taking calculated risks but not frittering and squandering their investment funds must be the alternative.

- Relevant to the above is that it is common in the literature to mention that the principle problems usually facing intermediate credit instituions as well as development banks is the lack of suitable projects or investment opportunities in a bankable form (Hock, 1967). Naturally this applies especially to Islamic banks. If this problem is attributed to the lack of business skill of the conventional banks, another crucial factor must be considered in the case of Islamic banks. It is simply the lack of moral and virtuous committments of many applicant entrepreneurs among whom one may find many skilful but dishonest persons.

- Another important aspect of the matter is that in a recessionary economy Islamic banks may be more harmfully affected than conventional banks. This was emphasised by both Dr. El Hilew (1986) the Governor of Faisal Islamic Bank of Egypt (FIBE) and Dr. Ahmed Amin Fuad (1986), the Chairman of the Cairo-based International Islamic bank. Dr. El Hilou's argument hinges on the assessment that most of the FIBE's clients are small and medium sized businesses. They are likely to be hit harder by the recession and do not have large reserves to fall back on. An Islamic bank suffers when business is bad regardless of the assets of the clients because its profits are calculated on the deal in question.

- Finally and more importantly is the connection between economic development and those factors which constitute the value judgements of the society. Since the earliest date of the discussion of economic development in the literature there was a widespread agreement among economists from different schools of thought that one of its prerequisites is a high degree of social mobility. In this respect, economists have called upon a reorientation of social norms and values which may create a climate favourable for economic development. Thus, for Islamic banks to help the economic development of their countries, a comprehensive, and in a sense, revolutionary cultural and educational process of transformation must take root in the society to penetrate widely and deeply and hence affects the psychological, the moral and the ideological facets of the *Ummah* (see Ahmad (1980), Anani (1980) and al Ansari (1984)). The fulfilment of such a job is by nature not restricted to Islamic banks and financial institutions only; it is essentially the duty of all members of the society.

4.3.8 Major Obstacles and Difficulties Facing Islamic Banks

Despite the remarkable progress that has been made by the individual Islamic banks and financial institutions, there are many difficulties and obstacles which are impeding their progress. Although it is planned to scrutinize such difficulties and obstacles in the empirical part of this study, where certain experiments are to be closely examined, it may be convenient at this stage, to outline some of the problems that most Islamic banks share in common. The major obstacles faced by Islamic banks were discussed by Muslim economists and bankers on different occasions. (see Atiyyah, 1981 and al Najjar, 1986). These difficulties mainly stem from, firstly the external factors which are related to the un-Islamic atmosphere in which they operate. Secondly and finally the internal factors which are related to the process of implementing Islamic banking and its technical and moral requirements. However, the enumeration of these difficulties is to be carried out in a general sense as follows:

1) The lack of appropriate staff who can enter the spirit of Islamic banking. Perhaps this is the most crucial dilemma from which many difficulties faced by Islamic banks are emerging. Most of the Islamic bank staff, mainly the top managers, have derived their experience from *riba* banks. Islamic banks as a manifestation of the moral-oriented system of Islam must be led by individuals inspired by the ideal of the Islamic bank. More important is the fact that the leaders should be selected from among those who had, besides technical competence, the ability to inspire the employees by being examples of the good, true and faithful Muslims. Over the past period of its development, the Islamic banking movement has unfortunately failed to satisfy such requirements. The experience of Islamic banks in training, which aimed to create a new generation of younger staff to carry the message of Islamic banks in the near and the distant future is unfortunately not encouraging. The unfortunate experiment of the International Institute of Islamic banking (IIIB) initiated by the International Association of Islamic Banks (IAIB), for training is one example. The huge cost of the project and the millions poured into it have been wasted when it was ended in 1984 after two years of work. In fact, the Islamic banks were unwilling to send students to the Institute. The International Institute of Islamic banking (IIIB) which was planning to train hundreds of students every year, found itself with almost no students in its second year. Many of the first batch of about a hundred students were unable to find a job. Surely the amount of money that was spent on each of them might have shown better returns. The banks were apparently dissatisifed with the way the Institute was run, and they were all convinced that it did not meet their needs. So, in 1984 the ambitious project finally had to be abandoned. The paradoxical nature of this Institute reflects a basic contradiction between the ideals of Islamic banking movement and the reality that it had become.

For the basic justification of the Institute was that Islamic banking needed its own persons; specially trained and very specialized. But this meant that the present generation of those who are at the helm of Islamic banking should do their best to train and prepare those "right people" who would then replace them completely. Nothing would convince them to break their necks in order to achieve such a goal (El Kattaby, 1985).

2) The hostile environment in which Islamic banks operate is a serious challenge to them. In most of their working locations Islamic banks are functioning in an economic, legal, administrative, cultural and social atmosphere where many un-Islamic features prevail in one form or another. Since such features contradict the philosophy of the Islamic banks this will undoubtedly affect their performance adversely. Detailed treatment of this point is provided in the empirical part of this study.

3) A vital example taken from the above mentioned point is the relationship between Islamic banks and Central banks in the countries in which they operate. This relationship was and still is rather tense. Although special laws were promulgated to exempt Islamic banks from the existing traditional banking rules they are still at a considerable disadvantage compared with conventional banks. Full details about the difficulties facing Islamic banks in this field are also provided in the empirical study of this thesis covering the Jordan Islamic Bank's experience.

4) Another important barrier which is impeding Islamic banks is of a religious jurisprudential (*fiqhiyyah*) nature. This is due to the divergence of views and opinions, resulting in the difficulty or even impossibility of achieving concensus. The need for having a standard *shariah* code which determins the permissable arrangements and operations in Islamic banks was voiced on different occasions. However, coordination among Islamic banks in this respect meets with several problems.

5) Islamic banks also face some technical problems. On the financial accounting front for example, Islamic banks are still suffering from the absence of Islamic accounting standards. Such standards have to be formulated on a basis that differs from the generally accepted accounting principles in the traditional banking system. Up to now, there are no uniform, developed accounting concepts or practices nor are there any particular rules which are widely accepted by Islamic banks in accounting for measuring, analysing, interpreting and communicating accounting data.

6) Another important problem which is currently faced by Islamic banks is the excess of liquidity. Although the implications of such a problem are discussed in

depth later on, there is one thing which remains important to be mentioned, so far, there is no institutionalized interbank market for Islamic banks.

7) The above problem of liquidity has also contributed to another difficulty which represents a genuine challenge to Islamic banks in present day. This is identified in the imbalance between achieving a satisfactory rate of return to both depositors and shareholders and contributing to socio-economic development through carrying out long-term investments. Maintaining a high level of liquidity, or a high degree of circulation through investing in short term finance projects, yielding a quick and high rate of return, will be at the expense of economic development.

8) The progress of Islamic banks is also hindered by a psychological barrier as the *riba* mentality is still influencing the attitudes of most people involved in the matter. The depositors expect a return equal to the *riba* market rate of return (the interest rate) if not more. The financed client is also expected to pay a yield equal to, or more than the interest rate in *riba* banks.

Only a minority give consideration to the priority of religious legality realizing the distinction between *halal* (religiously permissible) and *haram* (religiously forbidden) or appreciate the pioneering role rendered by the Islamic financing institutions or banks in applying Allah's course in an environment completely conflicting with the principles on which they are based.

9) Another impediment faced by Islamic banks is of a moral nature. Islamic banks sometimes fall into a trap of financing some entrepreneurs to whom *riba* banks refuse to make loans except against strong securities which they are not prepared to offer. Hence, out of their selfish desire to achieve their greedy goals such people may turn to Islamic banks. They approach Islamic banks under the pretence of righteousness and piety, claiming that they are being careful not to commit the sin of dealing in *riba.*

10) Islamic banks are remarkably suffering from the lack of coordination between them. More serious in this respect is the absence of the spirit of initiative and instead the presence of the spirit of enmity in some cases. Furthermore, the Islamic banking movement is in a sense tending to be held by a few rich families

and groups and hence affected by the struggle and the competition between them. In line with this, one also may hear about those who are occupying the job of chairman and member of board of directors or management in several Islamic banks and financial institutions.

11) Islamic banks also suffer from paying no concern to the publicisation of their message and to the clarification and explanation of their objectives and activities to the Muslim masses. In this respect, almost nothing has been produced in the public media of Muslim countries. In contrast, the Islamic banking movement is without doubt a target of a hostile campaign of irresponsible rumours launched on both local and international levels and motivated by all those who see in this movement a real threat to their interests.

Added to the list of difficulties mentioned above and perhaps the most serious challenge to the Islamic banking movement since its emergence is the story of the Islamic Investment Companies in Egypt. The success of these companies in dominating Egypt's private sector in recent years has attracted the attention of policy-makers both locally and internationally.

They emerged to collect savings, mostly from small middle-class families, and invest them in production and services operations. Names such as al-Rayyan, al-Sherif, al-Sa'd, al-Helal, al-Hoda Misr and Badr have become household names for increasing numbers of Egyptians. Millions have flocked to the Islamic investment companies because of non-interest dealings and the high rate of profit which they offer. Deposits collected by the 104 investment companies, identified by the Capital Markets Authority (CMA), from the public are estimated by Western economic experts at US $1.8 billion to US $3 billion. (*The Times*, 23 November 1988). Profits paid on deposits averaged 20 percent a year as against the 13 percent offered by Egypt's commercial banks.

Since early in 1987, warnings came out that such higher returns would be impossible to maintain but the authorities appeared reluctant to take action. This is partly because they realized that the huge amounts of cash already involved meant that the collapse of any of the main Islamic Companies above) could spark widespread social unrest (the largest, al-Rayyan, is estimated to have more than 150,000 depositors). The big crash happened when the government interfered to regulate these companies, alleged to have swindled hundreds of millions of pounds from small savers. An avalanche of Government mouthpieces took the line of calling for the banning of those companies that exploit religion (according to the government) for selfish, plundering ends. The companies - 104 in total - were required to present fully audited accounts to the Capital Markets Authority (CMA) if they intended to restructure and continue in business according to Law 146, passed in June 1988. Alternatively, they could declare their intention to liquidate their assets within two years. It is beyond the scope of this study to follow the rest of the story investigating the success of companies to comply with the new law, and the failure of some of the majors to do so. The whole affair has once more emphasised the fact that the Islamic financial movement is currently passing through a very critical period full of serious difficulties and challenges that are inimical to a favourable future. Thus, regardless of how different parties may respond to the ongoing story of the Islamic investment companies in Egypt it remains as a blatant outcry for action; otherwise hopes, efforts, and the funds of many Muslims will be wasted.

Chapter V

The Jordanian Economy: An Overview

5.1 Introduction

By the end of the 1980s*, Jordan will have completed four decades of development. Despite achieving an impressive growth rate, Jordan still faces a variety of problems and difficulties which need to be solved to avoid adverse effects on both its growth and future development plans.

The purpose of this chapter is to present a general view of the performance of the Jordanian economy throughout the course of its development.

This introduction is followed by a section on the history, geography and population of Jordan. It includes an historical and socio-political background and examines briefly the demographic characteristics of the country. The third section deals with the major factors of the Jordanian economy, and is divided into subsections.

It is in the context of these economic, social and political factors that the activities and performance of the Islamic banks must be evaluated

5.2 History, Geography and Population

5.2.1 An Historical and Socio-political Background

From the early sixteenth century until the end of the First World War in 1918, the area that became known as Jordan was incorporated into the Turkish Ottoman Empire.

It was King Hussain's great-grandfather Sherif Hussain's "Arab Revolt" against the Turks during this war that led to the disintegration of the Ottoman Empire and the placing of Palestine, Syria and Lebanon under the control of

* Data for the years after 1967 in this chapter includes the East Bank only.

Great Britain and France. The Arab Emirate of Transjordan was established on the east bank of the River Jordan in 1921 and was part of mandated Palestine. In 1946 Transjordan became Jordan, and was universally recognised as a sovereign state, with Sherif Hussain's son Abdullah being proclaimed King shortly afterwards.

Following the termination of the British government's mandate in Palestine in 1948, Jordan assumed an interest in the West Bank of the Jordan river and finally annexed it in 1950. King Abdullah was assassinated in 1951 and after a brief period of time his son Talal was declared insane and exiled to Turkey, making way for his son Hussain to become King. Despite several coup attempts, he has remained in power up to the present day.

Jordan ruled over the West Bank until 1967, and the Palestinians living there were entitled to Jordanian nationality. Today, approximately one million Palestinians, representing 60 per cent of the population of Jordan, live on the East Bank, with a further 800,000 living on the West Bank. The Palestinians share in both the economic and political life of the country. Since 1967, the West Bank has been occupied by Israel. The loss of the West Bank to Israel created a whole series of problems. The result was the loss not only of some efficiently farmed agricululturaI land, but also of the important and growing tourist industry, and the large sums in foreign exchange received from the people who annually visited the Old City of Jerusalem and Bethlehem. On July 31 1988, however, a dramatic move was surprisingly taken by King Hussain to sever Jordan's link with the West Bank. Decisions to halt a $1.3billion development plan for the West Bank and to dissolve the Jordanian Parliament to end representation for Palestinians living in the West Bank, immediately followed. The impact of such developments on the Jordanian economy and its current crisis will be highlighted in the next chapter.

5.2.2 Demographic Trends

As a centrally located Arab state, Jordan enjoys a geographic, demographic and political position within the broader Middle Eastern context. It is bordered by Syria to the north, Iraq to the east, Saudi Arabia to the south and Palestine (Israel) to the west.

Jordan occupies an area of 91,860 square kilometres and in 1984 had a population estimated at 2.90 million. (*Statistical Yearbook of Jordan* 1987, p.3). One of the most important characteristics of Jordan's demographic position is its high rate of population growth. During the period 1961-1979 it grew at an annual rate of about 5 per cent, of which 3.8 per cent represented natural growth, while the remainder resulted mainly from migration from the West Bank. During the period 1979-1984, an annual growth rate of 4.66 per cent was recorded. Jordan's mortality rate is 0.91 per cent, while life expectancy is 63.0 years for males and 64.2 years for females. (*Country Profile: Jordan*, (1986-87), p.7).

The age structure of the Jordanian population is characterised by the continuing predominance of youth. The percentage of those under 15 years of age to total population increased from 45 per cent in 1961 to 53 per cent in 1979. (*The Five-Year Plan* (1980-1985)).

Most of the major centres of population are located close to the River Jordan system. Average population density has increased, in absolute terms, from 10 persons a square kilometre in 1961 to 24 persons in 1980. (*Statistical Yearbook*, 1981, p.19)

In the past 18 years, the capital Amman has grown rapidly. Official statistics estimated that the population of "Greater Amman" was 1.2 million in 1987 (*Statistical Yearbook*, 1987, p.13)

5.3 The Main Features of the Jordanian Economy

5.3.1 A Free-Market Economy

The Jordanian economy is based on a free-enterprise system, with the government playing a major role in economic development (Chatelus, 1987). Economic policy aimed at bringing about cooperation between both the public and private sectors and in establishing socio-economic projects and providing an appropriate investment climate.

Despite the operation of a free-market system the government does exercise a certain measure of economic control and subsidises the prices of essential commodities such as wheat, meat, sugar, cooking and fuel oils, and cement. The government, therefore, seems to tread a path between socialism and capitalism.

The private sector, which the government treats with a considerable degree of deference, is allowed to conduct any legitimate business subject to the necessary regulations and without any administrative or official hindrance (Sullivan, 1987). This sector includes all companies in which the government is a participant. Representatives of the private sector are appointed to a number of councils, committees and boards*. They also join delegations that conduct trade talks with other governments. Jordan's economy is likely to remain based on a system of free-enterprise for the foreseeable future.

5.3.2 Limited Labour Force

Despite Jordan's high rate of population growth, relative to total population the labour force is small. In the last twenty years, the participation rate has remained almost constant at 20 per cent (*The Five-year Plan*, 1986-90). Several reasons account for this situation, including a large proportion of people under 15 years of age, low female participation rates and early retirement by a relatively high number of mothers. However, the most important single factor is the outflow of manpower, especially of the younger generation to other countries.

The oil exporting countries' boom saw Jordan exporting its skilled labour force in the 1970s and despite rumours concerning the return of many of its engineers, administrators and businessmen from the Gulf due to the present recession, demand in early 1986 was still holding up. In 1984 there were around 350,000 Jordanians working abroad (*Country Profile: Jordan*, 1986-87).

This outflow of workers has led to the importation of manpower from Arab and non-Arab countries. In 1985 there were approximately 130,000 non-Jordanian workers, the majority of them unskilled Egyptians working in agriculture and construction.

* These include: The National Consultative Council, the Central Bank of Jordan, the Industrial Development Bank, the Social Security Corporation, the Industrial Estate Corporation, and the Royal Jordanian Airlines Board.

Unemployment is officially estimated at between 8-10 per cent of the domestic workforce, which was estimated at 535,444 in 1986, by the government's Department of Statistics.

Jordan is making increasing efforts to tighten up on foreign labour and to produce goods in greatest demand at home, with community and vocational colleges trying to satisfy the demand for home-grown practical expertise, but as yet the institutions themselves and the skills they teach are regarded as inferior to a university education and insufficient for the high status occupations open to graduates.

5.3.3 Service-Oriented Economy

It is the sectoral distribution of the gross domestic product (GDP) which may or may not support the assumption that the Jordanian economy is a service-oriented one. Thus it is convenient to throw some light on the growth and the trend of the GDP since the mid-1970s, when the Jordanian economy started to enjoy sustained economic growth. Between 1974 and 1984 it had one of the highest growth rates in the world, with the GDP expanding, in real terms, at an average annual rate of more than 8 per cent (Fisher, 1987).

In spite of the problems brought about by the conflict with Israel and the uncertainty caused by the Iran-Iraq War, Jordan's economy remained surprisingly healthy at the beginning of the 1980s. Real GDP increased by 17.6 per cent in 1980 and by 9.8 per cent in 1981. The rate of inflation fell from 12 per cent in 1981 to 7.4 per cent in 1982, 5.5 per cent in 1983 and 3.9 per cent in 1984. In 1986 however, this favourable state of affairs did not last. In 1982 and in 1983 the rate of growth in GDP slowed to about 5.6 per cent and 2.5 per cent, respectively and fell to only 0.8 per cent in 1984, though it recovered to 2.1 per cent in 1986 and 3.1 per cent in 1987 according to the Central Bank (*The Annual Report*, 1987). It is also reported that inflation has fallen from zero in 1986 to -0.3 per cent in 1987. However, inflation has risen sharply in 1988-89, a consequence of the devaluation of the Jordanian Dinar, as will be explained in the next chapter. Under such development of the GDP, the sector's contribution to it can now be briefly examined.

Despite the fact that all the Jordanian development plans set for themselves the major objective of correcting the imbalance of this structure in favour of the commodity-producing sectors, the contribution of the services sector is still high. While the contribution of this sector in the GDP averaged at 62 per cent over the 1977-1987 period), the share of the productive sectors amounted to only 38 per cent for the same period (Table 5.1). It can be seen from the table that the major contribution of the service sectors was that of the government services followed by trade. In 1987 they accounted for 21.3 per cent and 16.3 per cent of the GDP respectively. Such a trend in the Jordanian economy can be understood through the weakness of the productive sectors which will be highlighted in the following subsection.

5.3.4 Structural Deficiencies in the Productive Sectors

Jordan's most crucial problem is the weakness of the productive sectors which suffer from structural deficiencies. Traditionally, these sectors have experienced many difficulties and hinderances which resulted in the stagnation of the productive activities of the country. In this regard, the two major productive sectors (agriculture and industry) are to be examined as follows:

1) Agriculture

Traditional agriculture's demise in a modernising economy was hastened in Jordan's case by the loss of all the West Bank production after 1967. The sector's share of GDP fell from 15 per cent in the 1960s (The Five-Year Plan, 1986-1990) to 6.5 per cent in 1979. Between 1977 and 1987 agriculture accounted for of the GDP, despite considerable investment outlays on irrigated farming and fruit and vegetable production in the Jordan Valley. With 92 per cent of its cultivable area rain-fed only the vagaries of rainfall are still a crucial factor in Jordan's agriculture. Wheat and barley production is concentrated in the country's rain-fed upland zone and has been adversely affected in recent years by drought. In 1985 the value of Jordanian food imports represented 70 per cent of the total value of Jordanian exports, and was about four times the value of the country's food exports (Fisher, 1987).

Table 5.1 : The sectoral distribution of the Jordanian gross domestic product (G.D.P), 1977-1987; factor cost (percentages).

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	Average
Agriculture	9.5	10.6	6.5	7.8	7.2	7.0	8.9	7.5	8.5	7.9	8.8	8.2
Industry	17.7	17.1	18.2	18.7	20.0	19.7	17.3	19.1	18.2	17.3	17.5	18.2
Electricity & water supply	1.2	1.3	1.5	1.9	2.0	2.2	2.3	2.6	2.5	3.0	3.1	2.1
Construction	8.4	9.9	10.5	10.9	10.6	10.4	10.2	9.7	8.2	8.1	7.0	9.5
Total of productive sectors	36.8	38.9	36.7	39.3	39.8	39.3	38.7	38.9	37.4	36.3	36.4	38.0
Trade	21.4	18.6	18.5	18.6	18.9	18.0	18.3	18.3	18.9	16.6	16.3	18.4
Transport & communications	8.2	10.7	9.4	8.9	9.9	10.6	11.1	10.9	10.5	11.2	11.1	10.2
Financing, retail estate & business services	10.9	12.2	13.6	11.8	10.7	11.0	10.9	11.0	11.1	11.9	11.9	11.6
Government services	19.2	17.2	19.3	19.0	18.4	18.7	18.7	18.1	19.0	21.1	21.3	19.1
Other services	3.5	2.4	2.5	2.4	2.3	2.4	2.3	2.8	3.0	2.9	3.0	2.7
Total services	63.2	61.1	63.3	60.7	60.2	60.7	61.3	61.1	62.6	63.7	63.6	62.0
Gross domestic product	100	100	100	100	100	100	100	100	100	100	100	100

Source : Central Bank of Jordan, *Annual Report*, 1987 ; Central Bank of Jordan, *Monthly Statistical Bulletin*, Vol. 24, No. 1, 1988 (Author's calculations).

The characteristics of agriculture and the problems facing it in Jordan are illustrated by the five-year plan as follows:

a) Characteristics:-

- Meagerness of agricultural resources, especially agricultural land and water.
- Instability of agricultural production due to excessive reliance on fluctuating climatic conditions.
- Land fragmentation and dispersal of holdings, hindering the economic use of production techniques.
- Availability of different zones, thus allowing for diversification and seasonal distribution of agricultural production.

b) Problems:-

- Absence of fixed agricultural policies. This leads to fluctuating decision-making which discourages the private sector from investing in long-term or large-scale projects.
- Continued deterioration of agricultural resources (soil, water, plant, cover, etc.)
- Low level of Government investment in the agricultural sector, coupled with concentration on certain activities or areas.
- Misuse, depletion and consequent salinity of underground water in certain areas.
- Low rate of farmers' participation in agriculture, a rise in the ratio of non-resident farmers and an increasing dependence on non-Jordanian labour.
- Low productivity, insufficient research and lack of training for farmers.
- Insufficiency of water studies ascertaining quantities of underground water and organizing its use in certain areas.
- Dearth of studies or guides on feasible investment opportunities in agriculture.

- Low marketing efficiency and weak enforcement of legislation on standards and specifications governing products or packaging. This has led to a relative loss of traditional markets.

- Low level of farmer participation in the decision-making process.

- Overlapping of ministerial and industrial authorities and jurisdictions, and insufficient coordination among the various bodies.

- Existence of product surpluses (for example in eggs and certain vegetables) and deficits (such as in field crops, red meat and certain fruits and vegetables) due to haphazard production unrelated to domestic and external demand.

- Lack of precise data on which to base planning or decision-making.

- Absences of coordination and integration among the Arab counries and existence of barriers to the exchange of agricultural products among them.

2) Industry (Manufacturing and Mining)

The manufacturing and mining sector has been seen as a major growth area, especially in terms of government investment in schemes to develop the country's phosphate and potash resources. During the 1981-1985 plan period manufacturing and mining were together, expected to achieve an annual growth rate of 17.8 per cent accounting for 29.3 per cent of GDP by its end. However, the initial momentum in this sector was not maintained and its share of GDP has slipped back slightly since the first year of the plan. This share has declined from 20 per cent in 1981 to 17.5 per cent in 1987. (Table 5.1) About 65 per cent of all factories produce food products or clothing but the major industrial income derives from the three heavier industries - phosphate extraction, cement manufacture and petroleum refining (Fisher, 1987). In the five-year plan for economic and social development (1986-1990) special attention has been given to the long-lasting problems of the industrial sector which were illustrated as follows:-

- Lack of interconnections between the industrial and other sectors, particularly agriculture, resulting in a relative underdevelopment of the food industries.

- Lack of interconnections among the various industries themselves.

- Continued dependence by the transforming industries on imported intermediate and raw materials, some of which are subject to higher customs duties than those levied on finished imported goods.
- Insufficiency of technical manpower, and lack of an appropriate mechanism to regulate the supply of industrial labour.
- Weakness of domestic capabilities and expertise in the areas of:
    - marketing,
    - project evaluation,
    - scientifically based management of industrial projects.
- Dearth of statistical data on the industrial sector. Also lack of a national system to supply researchers with accurate and up-to-date tables on production, consumption, labour and other areas of significance.
- Weakness of domestic expertise in the preparation of feasibility studies on large-scale projects, coupled with insufficient participation in studies performed by foreign consultants, with the result that studies are not based on full knowledge of the domestic or regional investment climate - a factor affecting the soundness of their findings.
- Narrowness of the domestic market and consequent inability to absorb Jordanian industrial products. This, together with flooding the market with competitive imports, leads to production surpluses.
- Limited potential for industrial export as a result of insufficient integration and cooperation at the Arab level.
- Inadequacy of measures and procedures governing export promotion and insurance. Also, inadequacy of marketing supervision and promotion in external markets.
- High cost of domestic inputs and services, such as energy. Also, shortage of shipping facilities at competitive prices to the natural markets for Jordanian products.

- Inadequacy of tax incentives to encourage industrial exports and investments therein, such as:
  - tax exemptions on profits realized from exports,
  - accelerated depreciation on machinery and equipment,
  - tax deductions to industries operating research and development centers,
  - tax exemptions on reinvested profits,
  - partial tax exemption on the profits of establishments with staff training programs.
- Concentration of industrial investments in the Amman Governorate resulting in the lack of industrial services outside the capital.
- Cumbersome procedures on the temporary entry of goods, duty refunds and exports.
- Continued prevalence of small-scale industries within the overall industrial structure in Jordan.
- Inadequacy of existing legislation, specially in respect of:
  - Company Law
  - Encouragement of Investment Law
  - Labour Law
- Absence of an industry law.
- Multiplicity of agencies involved with the establishment of industries.
- Limited volume of Arab and foreign investments in Jordanian industries.

5.3.5 Heavy Dependency on the External World

Like all other developing countries, Jordan has historically maintained a heavy dependency on the external world. This dependency, however, has manifested itself in various ways which need to be illustrated as follows:-

5.3.5.1 Heavy dependence on foreign aid

The persuance of the economic development drive of Jordan shows a heavy historical dependence on foreign aid. This dependence has been emphasised since the early 1950s when the World Bank sent a mission to study the Jordanian economy. The mission reported that the country was heavily dependent on foreign aid (International Bank for Reconstruction and Development, 1957, p.5), and as such the Jordanian economy was categorized as a dependent one.

Foreign aid is still considered as a major source of funds for the Jordanian Government to balance its budget. In the early 1970s, the reltive share of external revenues amounted to 65 per cent of total public revenues (Gharaibeh, 1987, p.8).

As for the sources of these revenues, until the mid-1950s the State budget was topped up by the British who in particular paid for the upkeep of the Jordanian army. The United States took over the role of paymaster from the British and the Arab oil producing countries in turn replaced the United States in the late 1960s.

Moving from the general to the specific, the United States aid to Jordan was always given on the basis that it comes to serve the interests of America in the region. In line with this argument, the Agency for International Development (AID) has defined the United States interests and objectives in extending aid to Jordan as follows:

> "The primary objective of AID's programme in Jordan is to assist development of a moderate, western-oriented state that i. socially and politically stable. For thirty years, USA economic assistance has been an important component of the USA presence in Jordan". (AID, 1983, p.70)

Dependence on foreign aid, from either the East or the West ultimately threatens the political as well as the economic independence of the Country. As foreign assistance takes the form of both grants and borrowings constituting the external revenues in the state budget, these revenues are to be examined over the last decade from different aspects.

One indicator reflects the risk of this dependence on external revenues is its proportion to GDP. Table 5.2 shows that this proportion was 41.1 per cent in 1977, but declined to 15.5 per cent in 1987.

Table 5.2 : The growth of external revenues and their proportion to total revenues and GDP in Jordan, 1977-1986. (JD million)

Year	External revenues	Rate of growth %	Proportion to total revenues %	Proportion to G.D.P %	Total revenues
1977	180.71	109.8	53.5	41.1	337.96
1978	172.40	-4.6	49.7	31.2	346.88
1979	247.93	43.8	53.0	36.3	468.17
1980	280.87	13.3	53.5	31.4	525.02
1981	282.70	0.7	45.8	27.2	617.12
1982	264.85	-6.3	40.4	22.6	555.25
1983	273.82	3.4	38.8	22.0	705.48
1984	228.30	-16.6	33.7	17.3	678.43
1985	350.25	53.4	41.5	25.6	844.80
1986	303.48	-13.4	33.5	21.6	905.42
1987*	223.87	-26.2	23.9	15.5	937.47

* Preliminary

Source : Central Bank of Jordan, *Monthly Statistical Bulletin*, Vol. **24**, No. 1,1988 and Vol. **25**, No. 4, 1989 (Author's calculations).

In addition, it can be argued that the uncertainty of external revenues also threatens the process of economic development of the country. In line with this, Table 5.2 shows a sharp year by year fluctuation in the growth rate of the external revenues and its share of the total revenues. While its rate of growth amounted to 43.8 per cent in 1979 against -26.2 per cent in 1987, the contribution to the total revenues declined from 53 per cent to 23.9 per cent in the respective years.

This can be partly explained by the demise of United States' aid since 1981 as well as that from the Arab rich countries. Due to the decline in the oil revenues and the Gulf war, Jordan was deprived of what was pledged to the so-called frontline states at the Arab League Summit in Baghdad in 1978. Engulfed in a disastrous war, Iraq for instance, was soon unable to honour the commitment it had made to Jordan ($200 million) at the Baghdad Summit. Only Saudi Arabia and Kuwait continue to pay Jordan the full amount as agreed (and in 1984 even Kuwait fell short of its commitment*) (Rivier, 1987, p.196).

As a consequence of this dependence on external revenues, Jordan's external debt has grown steadily throughout the present decade reflecting the view of the country among the International banking community as a good risk.

Overall, total external debt rose by 102 per cent in the five years from 1982 to 1987 when it stood at JD 1.26 billion, although this does not tell the whole story as it does not include the full extent of external mlitary debt.

Despite the contradictions among the different sources of official data available, the proportion of the external debt and the repayments to GNP has increased (according to the Central Bank data) from 42.2 per cent in 1982 to 65.7 per cent in 1986, if this data is to be trusted.The proportion of the external debt and the repayments is more alarming, in 1986 this proportion peaked at 90 per cent. (Table 5.3)

Recently there has been great concern about external loans repayment among Jordanians. This was increased from JD 81.25 million in 1982 to JD 190.7 million in 1986 on account of principal (JD 81.80 million) and interest (JD 66.60 million). Interest payments on the government's external debt came to nearly JD 48.8 million in 1987 compared with JD 11.2 million in 1982 (CBJ, *Monthly Statistical Bulletin*, different issues).

Coupled with the decline in exports of goods and services this increase pushed the external debt service ratio† from 7.2 per cent in 1982 to 17.5 per cent in 1987. (Table 5.3)

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* In 1984 the Parliament of Kuwait said that its contribution to Jordan should be greatly reduced. In 1985 Kuwaiti MPs voted that aid to Jordan should stop if Jordan was contemplating peace talks with Israel. (Robins, 1987, p.33)

† Measured by the percentage of interest and principal repayments to exports of goods and services, i.e. (2) : (5), in Table 5.3.

Table 5.3 : External public debt of Jordan and its burden, 1982-1987.
(JD million & percentages)

Year	Outstanding balance (1)	Repayments (principal & interest (2)	(1)+(2) as a % of G.N.P (3)	(1)+(2) as a % of G.D.P (4)	Exports of goods and services (5)	Debt service ratio, (2):(5)
1982	624.50	81.25	42.20	60.30	1121.93	7.20
1983	815.05	80.39	50.80	72.10	1103.92	7.30
1984	959.74	92.71	56.70	80.00	1257.95	7.40
1985	1054.58	120.35	63.50	85.90	1221.55	9.90
1986	1110.70	148.40	65.70	90.00	1080.67	13.70
1987	1261.60	190.70	67.50	87.17	1091.00	17.50

Sources : Central Bank of Jordan,*Annual Reports*, 1986,1987. *Monthly Statistical Bulletin*, Vol. **24**, No. 1, 1988 (Authors calculations).

5.3.5.2 Heavy dependence on remittances from Jordanians working abroad

The Jordanian economy depends heavily on remittances from Jordanians working abroad. As a result of oil price increases in the 1970s there was a heavy demand for imported labour in the Arab oil rich countries and Jordan had been classified as a major supplier of skilled and educated manpower in the region.

Remittances from Jordanians working abroad contributed significantly to economic growth. The magnitude of remittances and their importance over the last decade is shown in Table 5.4. Prior to 1973 expatriates' remittances were of scant importance but they grew rapidly between 1975 and 1981. Table 5.4 shows that they constitute a major source of hard currency for Jordan. They peaked in 1984 when they amounted to JD 475 million, but then declined to reach JD 402.92 million in 1985 registering a negative rate of growth of -15.2 per cent. However, during the last decade these remittances have surpassed in importance all visible exports of the country.

They have significantly contributed to financing the balance of trade deficit. Their tremendous effect on the economy can be reflected in their proportion to GDP. This proportion amounted to 36.1 per cent in both 1976 and 1984, but decreased to 21.9 per cent in 1987 (Table 5.4).

In addition to their impact on the economy at the governmental level, remittances permit a higher standard of living, ownership of land and houses, savings in the form of cash or gold, and investment in income-producing property or financial investments like shares and bonds for the family. Despite all the above positive effects of these remittances on the Jordanian economy they also have adverse effects on both economic and social aspects of Jordanian society. Some of these effects can be classified as follows:

- Although remittances have played a major role in financing the deficit in the balance of trade, they have contributed to the growth of imports. It can be argued, of course, that without the substantial level of these remittances imports would have been much lower and available labour in Jordan would have reduced unit costs, thus stimulating exports to a certain extent (The Royal Scientific Society, 1983, pp.85-86).

Table 5.4 : **The development of remittances from Jordanians working abroad, 1976-1987. (JD million & percentages)**

Year	Remittances	Rate of growth %	Proportion to G.D.P, %	Proportion to exports**,%
1976	136.41	156.2	36.1	198.5
1977	154.75	13.4	35.1	188.6
1978	159.38	3.0	29.0	175.3
1979	180.42	13.2	27.0	149.2
1980	236.68	31.2	26.5	138.0
1981	340.89	44.0	32.7	140.5
1982	381.90	12.0	32.6	144.4
1983	402.90	5.4	32.4	191.3
1984	475.00	17.9	36.1	163.4
1985*	402.92	-15.2	29.5	129.6
1986*	414.53	2.8	29.6	161.9
1987*	317.74	-23.3	21.9	100.8

* Preliminary

** Goods only

Source : Central Bank of Jordan, *Monthly Statistical Bulletin*, Vol. 24, No. 1, 1988 and Vol. 25, No. 4, 1989.

- The number of highly skilled emigrants reached about 35,000 in 1984. Although this helps maintain the volume of remittances sent back to Jordan it deprives the country of skills and talents, the absence of which may obstruct development efforts. Accordingly, many positions left vacant were filled by foreign workers bringing about a phenomenon of counter-remittances. In 1984, it was estimated that the 153,000 emigrants most of whom were Egyptians, accounted for a large flow of funds out of the country totalling JD 97.5 million and representing about 20 per cent of the inflow of funds from Jordanian workers in the Gulf (*The Five-Year Plan* (1986-90)).

- The crucial role of these remittances for Jordan and its inhabitants has led to attitudes and behaviour widely found through the Arab countries with only slight variations. In as much as a significant proportion of the population depends for their living on income for which nothing is given in return, behaviour is powerfully influenced in ways not formulated to encourage the sort of creative activity required by a diversified, productive economy. Economic agents (individuals, groups, businesses, and so on) tend to play down the importance of real economic results in favour of revenue-allocation strategies, which leads to anti-productive inclinations or at the very least, to: inclinations that do not encourage production (Chatelus, 1987).

In line with the above argument, it can be added that workers' migration has adversely affected the process of social change in Jordan. Large-scale migration of workers, many of whom leave their families behind can obviously affect social behaviour due to the absence of the family members and increased resources from remittances, and even after the migrant's return there can be problems of readjustment.

- It is obvious that the continuation of these remittances depends on the oil situation at both the regional and the international level. Thus, due to the drop in their revenues since 1982 the oil exporting countries have introduced many restrictions on immigration and have dispensed with many migrant workers most of whom are Palestinians who hold Jordanian Passports*. This, of course, was reflected on the negative rate of growth of remittances achieved in 1985 and accelerated in 1987 when it reached -23.3 per cent (Table 5.4).

It is apparent then, that this source of funds for Jordan also maintains a high degree of uncertainty. Jordan's future revenues in this form will therefore depend heavily on being granted 'special treatment' by the oil states.

5.3.5.3 Full dependence on imported energy

Jordan is overwhelmingly dependent on imports of crude oil to satisfy its energy needs. Expenditure on oil imports has risen continuously. They rose fivefold in the five years from 1978 to 1982 when they peaked at JD 231.92

* Oil states have recently tended to prefer Asian workers, whose claims are more moderate as regards pay as well as social and political rights or permanent settlement (Weiss, 1987, p. 155).

million. The transport sector consumes about half of the total refinery output. In 1985 it accounted for 41 per cent of the 2.76 million tons of oil consumed that year, putting it ahead of all other sectors in this respect. Electricity generation accounted for 25 per cent of the total with the industrial sector using 16 per cent and the domestic market 12 per cent (Robins, 1987, p.75). In 1985 Jordan imported 2.5 million tons of oil. Although this represented a small reduction of 132.000 on the previous year it still cost the country JD 193.3 million. Crude oil was therefore Jordan's most expensive non-military import. Costing nearly JD80 million more than imports of electrical and non-electrical machinery which amounted to JD 112.77 million for the same year (CBJ, *MSB*, Vol. 24 No. 1, 1988).

Despite the decline in the country's energy bill over the period 1982 to 1986 reflected in the negative growth rate of the bill of -42.6 per cent at the end of this period (Table 5.5), the country does not appear to be well placed to take advantage of the falling price of oil. Moreover, the value of its imported energy increased again in 1987 with a 34.2 per cent rate of growth.

Its main supplier, Saudi Arabia, was still billing Jordan for the official OPEC price of $28/b in April 1986. Jordan's other source of oil, Iraq, was supplying the country with crude at $22/b (This was at a time when spot market prices were around $10/b.). Moreover, with the new OPEC agreement in June 1987 to consolidate the oil price at $18/b, there seems little prospect of anything other than a substantial increase in the country's energy bill. This in turn will widen the balance of trade deficit (which contracted in 1986) and put the foreign exchange reserves and balance of payments current account under more pressure. Furthermore, it will increase costs for the hard pressed manufacturing sector in terms of the cost of its products.

The increased cost of oil is also likely to put electricity prices back up, thus also increasing overheads for the services sector.

Hopes have been placed on domestic oil exploration, as well as in alternative energy sources in the solar and wind-power sectors. Following decades of a fruitless oil search, two of Jordan's experimental oil wells have now yielded their first

Table 5.5 : **The growth of imported energy of Jordan, 1977-1986. (JD million)**

Year	Volume	Rate of growth %
1977	43.04	-
1978	46.77	8.7
1979	74.00	58.2
1980	122.15	65.1
1981	176.13	44.2
1982	231.92	31.6
1983	207.39	-10.6
1984	205.20	-1.1
1985	193.60	-5.6
1986	111.07	-42.6
1987	149.04	34.2

Source : Central Bank of Jordan, *Statistical Monthly Bulletin*, Vol. **24**, No. 1, 1988 & Vol. **25**, No. 4, 1989.

crude oil since the oilfield was originally discovered at the end of 1983, but the quantities are minimal (*Country Profile, Jordan*, 1987-88).

5.3.5.4 Significant dependence on food imports

Jordan falls into the classic mould of a less developed country, in terms of its food security. Whereas Jordan is a net exporter of fruit and vegetables, most of its staple foods, and also all of its needs of meat, fish and cereals have to be imported. During the period of the boom the value of imported foodstuffs rose by 145.5 per cent in the five years from 1977 to 1982 when it stood at JD 177.32 million whereas the exports of food were found to be JD 40.09 million (Table 5.6).

While the Government concentrated its efforts on adopting export orientated policies in industrial and agricultural sectors, it has ignored the domestic needs for food. In the agricultural sector, the priority for government investment has gone to the Jordan Valley where the production of fruit and vegetables has been primarily for exports. The traditional areas of farming in the rainfed uplands, which grow basic cereal and fodder crops, have been largely ignored. As a result, imports of wheat and flour have grown substantially; in 1983, for instance, they cost the country JD 32.3 million, which is very significant if it is compared to the earnings from exports in the same year which stood at JD 36.08 million (Table 5.6).

Table 5.6 : The growth rate of exports and imports of foodstuff for Jordan, 1977-1987.

Year	Imports	Growth rate of imports	Exports*	Growth rate exports	Deficit	Growth rate of deficit
1977	72.21	-	18.54	-	-53.56	-
1978	85.62	18.57	16.89	-8.89	68.73	28.32
1979	100.63	15.01	21.55	16.89	79.08	15.06
1980	112.63	11.92	24.29	12.71	88.34	11.71
1981	156.47	38.92	34.04	40.14	122.43	38.58
1982	177.32	13.32	40.09	17.77	137.23	12.09
1983	157.11	-11.39	36.08	-10.00	121.03	11.80
1984	161.11	2.54	35.02	-2.94	126.09	4.18
1985	152.55	-5.31	36.77	4.99	115.78	-8.17
1986	134.36	-11.92	29.42	19.98	104.94	-9.37
1987	132.09	-1.69	31.80	8.08	100.29	-4.43

* National exports.

Source : Central Bank of Jordan, *Monthly Statistical Bulletin*, Vol. **24**, No. 1, 1988; Vol. **25**, No. 5, 1989 (Author's calculation).

5.3.5.5 Heavy dependence on foreign expertise in science and technology

Some basic problems of economic development in Jordan are those closely related to the application of science and technology. These problems are particularly pronounced in the sectors of energy, agriculture, water, irrigation, land use and the environment. To meet these problems Jordan, like all less developed countries (LDCs), depends heavily on foreign expertise and technology. Most of the applied studies and research in the various sectors have largely depended upon foreign expertise. As the supply of this expertise is ultimately dependent on foreign interests in the country, there has been a lack of research geared towards solving these problems locally. All domestic attempts to apply science and technology to development have not generally been confined to priority development projects. In addition, the institutional framework as well as the basic infrastructure necessary for the application of such activities still remain incomplete or undefined (*The Five Year Plan* (1981-1985), p.22).

5.3.6 A Chronic Balance of Trade Deficit

As Jordan is a small country whose productive base does not ensure the minimum level required for self-sufficiency in capital, intermediate or consumer goods, it resorts to importation on a wide scale.

Accordingly, Jordan has operated a liberal trade policy and has tried to promote itself as a regional centre. However, the right to import is restricted to resident Jordanians possessing a trade licence, to registered companies (with at least 51 per cent Jordanian ownership - *Jordan Economic Investment Law No. 53*, 1972), to organizations covered by the encouragement of investment law, and to foreign firms working on government contracts.

In an effort to establish itself as a regional entrepot, Jordan has established two free zones in Aqaba and Zarqa, and has two more planned for the international airport and at the border point with Syria.

Jordan's most important trading partners are her Arab neighbours. In 1986 Arab countries purchased over 45 per cent of Jordan's domestic exports. In 1985 this table was 51 per cent. Iraq is the single largest market, accouting for a fraction over half the total of 1985 exports and for nearly 19 per cent of the grand total of 1986. India (non-Arab) then came second, mainly due to its purchase of phosphate, which earned 25.9 per cent of Jordan's export income, and Saudi Arabia the third. The European Economic Community was collectively Jordan's largest single supplier providing nearly JD 315 million out of total imports of JD 1,074 million in 1985, and over JD 229 million out of total imports of JD 850.2 million in 1986. In 1986 Iraq was the biggest individual source of imports with JD 80.3 million worth, followed by the United States, Britain and Japan (*Country Profile, Jordan* (1987-88)).

The hallmark of Jordan's foreign trade is the trade balance deficit. It has been a characteristic feature of Jordan's economy throughout the various stages of its development.

The state of Jordan's trade balance over the last decade is portrayed in Table 5.7. It is apparent from the table that imports grew faster than exports. The latter usually constitutes only about 20 per cent of imports. Government statements have always emphasised the aim of increasing exports and reducing imports as a dual strategy for eroding the trade deficit. In practice, however, the deficit grew from from JD 371.05 million in 1977 to JD 891.3 million in 1985. Only since that year has the deficit started to decrease (Table 5.7). It plunged from JD 761.6 million in 1985 to JD 591.8 million in 1986, that is by JD 169.8 million or 22.3 per cent which was a record drop in the period since 1967. As exports registered a decline of 17.6 per cent during the same year, this shift was mainly attributed to the decline of the country's imports bill (21 per cent) which stemmed from the decline in oil prices as well as the Government's tendency to dampen demand of luxuries through increased import duties. In 1987, however, the deficit rose again as the increase in imports exceeded that of exports (see the table).

To illustrate the significance of the balance of trade deficit which appears to be structural, the ratio of this deficit to GDP during the last decade is to be considered. Over the period under consideration, this ratio fluctuated between 72.2 per cent in 1977 to 36.7 per cent in 1986. In 1987 it was found to be 41.2 per cent which is still significant.

Table 5.7 : The trade balance of Jordan, 1977-1987.

Year	Exports(E)	Exports rate of growth %	Imports(I)	Imports rate of growth %	E/I ratio %	Trade deficit (E-I)	Trade deficit/ G.D.P ratio %
1977	82.06	19.4	453.11	33.8	18.1	371.05	72.2
1978	90.92	10.8	458.93	1.3	19.8	368.01	58.2
1979	120.92	33.0	588.32	28.2	20.6	467.40	62.1
1980	171.42	41.8	714.79	21.5	23.9	543.34	55.2
1981	242.62	14.5	1046.36	46.4	23.2	803.77	69.1
1982	264.53	9.0	1141.12	9.1	23.2	876.59	66.3
1983	210.59	20.5	1101.96	-3.4	19.1	891.37	62.7
1984	290.66	38.2	1069.19	-3.0	27.2	771.53	51.5
1985	310.89	6.9	1072.51	0.3	28.9	761.62	48.4
1986	256.03	-17.6	847.83	-21.0	30.9	591.80	36.7
1987	315.17	23.1	912.58	7.6	34.5	595.87	41.2

Source : Central bank of Jordan, *Monthly Statisical Bulletin*, Vol.24, No.1, 1988; Vol.25, No. 4, 1989 (Authors calculation).

Despite the seemingly hopeless chronic deficit in the trade balance, Jordan's balance of payments was marked sometimes by surpluses in the current account. Besides invisible services, remittances from Jordanians working abroad and foreign aid were the main sources which were able to offset the deficit in the trade balance until 1980. Since 1981, Jordan has been unable to make good its visible trade deficit through invisibles and aid has therefore registered considerable deficits on its balance of payments' current account. The cumulative deficit of the four years up tp 1984 was JD 376.5 million (*Country Profile, Jordan*, (1986-87), p.27). With remittances growing in real terms up to 1984, the main reason for this turn around has been the serious decline in Arab aid.

5.3.7 Excess Consumption Over GDP

One of the permanent features of the Jordanian economy is that the total consumption (public and private) always exceeds the GDP. This traditional characteristic is emphasised by data provided by *The Five-Year Plan* (1986- 1990) in its review of the phases of development of the Jordanian economy.

During the period (1952-1966), its volume at current prices increased from JD 53.1 million in 1952 to JD 188.8 million in 1966, at an annual growth rate of 9.5 per cent. The ratio of public consumption to total consumption fluctuated between 19.8 per cent and 25.9 per cent and of 21.7 per cent for the entire period. Its ratio to GDP at market prices in 1966 amounted to 110.7 per cent.

During the period from 1973 to 1980, the volume of total consumption recorded a noticable increase reaching an annual growth rate of 20.2 per cent in current prices. Private consumption was largely responsible for this increase, reaching an annual growth rate of 21.2 per cent while that of public consumption reached 17.2 per cent. The ratio of total consumption to GDP at current prices amounted to 127.2 per cent in 1979 (Table 5.8). However, during the last decade the growth rate of consumption registered a remarkable decline as it fell to 6.6 per cent by 1986 but in 1987 it rose again. Also, the ratio of consumption to GDP remained at a high level, although it declined from 119.2 per cent in 1983 to 103.5 per cent in 1987.

As the official sources put it, this high level of consumption to GDP of course

Table 5.8 : The growth of domestic consumption and its percentage to G.D.P at current market prices in Jordan, 1977-1987. (JD million)

Year	Private consumption	Public consumption	Total consumption	Growth rate of consumption,%	G.D.P at market prices	Total consumption to G.D.P,%
1977	470.5	156.6	627.1	-	514.2	122.0
1978	560.4	190.0	750.4	19.7	632.2	118.7
1979	722.6	235.3	957.9	27.7	753.0	127.2
1980	829.3	243.8	1073.1	12.0	984.3	119.1
1981	1053.2	285.9	1339.1	24.8	1164.2	115.1
1982	1219.5	326.1	1545.6	15.4	1321.2	117.0
1983	1348.1	348.3	1696.4	9.8	1422.7	119.2
1984	1373.9	376.9	1750.8	3.2	1498.4	116.8
1985*	1401.7	405.2	1806.9	3.2	1605.9	112.5
1986*	1238.4	449.9	1688.3	-6.6	1639.9	103.0
1987*	1238.4	459.8	1698.2	0.6	1639.3	103.5

* Preliminary

Source : Central Bank of Jordan, *Monthly Statistical Bulletin*, Vol. **22**, No. 6, 1986; Vol. **24**, No. 1, 1988 & Vol. **25**, No. 4, 1989.

reflects a weakness in the national economic structure which manifested itself in the failure of domestic product to meet domestic demand, allowing external factors to come into play (*The Five-Year Plan* (1981-1985), p.18).

5.3.8 High Military and Security Expenses

Another important and one of the most striking characteristics of the Jordanian economy is the high level of military and security expenditure.

The military burden imposed on Jordan throughout the course of its economic development can be identified by two factors:

- The exceptionally large share of GDP Jordan historically devoted to the public administration and defence sectors. This can be seen in Table 5.1 presented earlier and in which government services accounted for 21.3 per cent of the GDP in 1987.

- The high proportion of the defence and internal security expenditure to total expenditure in the Government budget. During the last decade this expenditure increased from JD 96.98 million in 1977 to JD 269.36 million in 1987, with a contribution to the total expenditure of 28.7 per cent and 26.7 per cent respectively (Table 5.9).

Internal Security expenses constitute a major proportion of the military budget of the country. In 1987*, its share of the total military expenditure amounted to 22.4 per cent when it reached JD 60.36 million.

It is worth mentioning here that the Jordanian Government spends a significant sum on improvements to its own buildings and premises, aimed at increasing its prestige and standing. This tendency has clearly been emphasised by the allocations in the last Five-Year Plan for 1986-1990. Funds worth JD 39.9 million have been devoted to Government buildings over the period. Of this, JD 13.6 million was allocated for buildings belonging to the Ministry of Interior, whereas only JD 3.7 million was planned to meet the needs of the Ministry of Education buildings over the same period. Moreover, the plan has also included funding

* In this year less than one million dinar (i.e. JD 885,000 of the state budget were allocated to finance Awqaf and Islamic affairs projects. according to the Five-Year Plan of 1986-1990.

Table 5.9 : **Defence and internal security expenditure of Jordan, and its relation to total Government expenditure, 1977-1987. (JD million)**

Year	Defence & security expenditure			Total	(3)/(4)
	Defence(1)	Internal security(2)	Total(3)	expenditure(4)	ratio %
1977	82.56	14.42	96.98	337.83	28.7
1978	88.91	16.64	105.55	361.51	29.2
1979	114.87	23.04	137.9	515.66	26.7
1980	118.18	24.69	142.87	563.14	25.4
1981	138.0	30.22	168.22	647.1	26.0
1982	156.65	34.65	191.3	656.28	29.1
1983	168.0	36.0	204.0	705.27	29.0
1984	168.0	36.84	204.84	720.81	28.4
1985	190.2	43.18	233.38	805.68	29.0
1986	209.0	51.66	260.66	981.34	26.6
1987	209.0	60.36	269.36	1008.75	26.7

Source : Central Bank of Jordan, *Monthly Statistical Bulletin*, Vol. **22**, No. 6, 1988 & Vol. **24** No. 1, 1988.

worth JD 200,000 for the construction of two houses for governors in Zarqa and Mafruq Governates (see *The Five-Year Plan*, 1986-1990). Given the fact that Jordan still suffers from a housing problem, this amount of funds could easily help to improve living conditions or to provide suitable shelter for at least 40 low-income families.

5.3.9 Absence of a Convenient Development Planning Approach

Due to its lack of natural resources and its dependence on the financial goodwill of its neighbours, Jordan has never been able to realize a very stringent development concept (Mazur, 1979). This will become clear by examining Jordan's national plans since the early sixties. The first official development plan for Jordan was The Five-Year Plan 1962-67, proposed by the Jordan Development Board (JDB). This plan was replaced in 1963 by a seven-year plan (1964-70), with planned investments of JD 275 million. However, this plan appeared to have been somewhat unrealistic in its aggregative projections. The 1967 War and its aftermath made this plan obsolete too. In the wake of the above war and for almost five years afterwards, marked by enormous political uncertainties, economic development in Jordan was not carried out in any systematic manner.

In 1973, the newly formed National Planning Council (NPC) proposed a three- year plan (1973-75). The plan envisaged an annual growth in GDP at factor cost of 8 per cent with investments of JD 179 million. According to this plan, the most rapid growth was to be in the sectors of electricity and water, mining and manufacturing and construction (*The Three-Year Development Plan* (1973-75), p.24). In a period of transition, several striking considerations occured that could not have been foreseen when the plan was drawn up; the oil price revolution, the absorption of Jordanian manpower abroad, acceleration of world inflation, the rise in phosphate prices and a great increase in the financial aid extended to Jordan.

In spite of the favourable impact of the above factors on the Jordanian economy, a variety of circumstances contributed to the failure of the Three- Year Plan. In part the plan was overambitious, failing to allow sufficient time for project formulation and preparation. The 1973 Middle East War, delays in receiving equipment and inflation in their costs due to worldwide and regional influences, shortages of trained manpower because of the employment opportunities in the newly enriched oil-producing countries of the region, all were unpredictable elements outside Jordan's control contributing to delays and cost overruns in planned projects. Weaknesses in the NPC's handling of project preparation and implementation also played a role (Mazur, 1979, p.248).

The following plan was the first Five-Year Plan for 1976-1980, prepared in 1975. The targets set in this plan were as follows: a) an 11.9 per cent annual real growth of GDP; b) a 16.5 per cent annual real increase in domestic revenues, increasing their share of total revenues from 51 per cent in 1975 to 68 per cent in 1980 and their proportion to current expenditures from 61.5 per cent in 1975 to 91.5 per cent in 1980; c) a reduction of the trade deficit from JD 153 million in 1975 to JD 131 million in 1980; d) a balanced development of all regions (*The Five-Year Plan* (1976-1980)).

As for the achievements, the ambitious Five-Year Plan (1976-1980) fell short of its objectives in several respects. Real annual growth of GDP averaged about 8.5 per cent instead of the 11.9 per cent forecast. The total table of investment spending exceded the planned targets by 10.3 per cent, although the distribution among sectors was very uneven. The targets set for a number of manufacturing sectors, as well as for mining, electricity and water supply, were not met as a result of lower than expected growth in phosphate production and the delays incurred in the fertilizer project. Construction and agriculture, on the other hand, performed better than anticipated.

The growth rate of domestic revenues in the Government budget did not exceed 9 per cent per annum and total domestic revenues reached only JD 129.5 million. The trade deficit, instead of being cutback, expanded during the period to reach approximately JD 500 million, again attributed to the shortfall in phosphate output, while the uneven distribution of per capita incomes between rural and urban areas, and between the southern parts and the rest of the country has not been corrected (Khader, 1987). Thus, the Five-Year Plan (1976-1980) seemed to be clearly over-optimistic in its high investment programme which also made it over-ambitious in its aggregate economic projections. It is obvious that it was the ready availability of foreign aid that prompted the high level of investment and the big projects strategy.

The following development plan was the second Five-Year Plan (1981-1985). The plan embodied quite similar development objectives to its predecessor of 1976-80. However, profiting from the previous experience, targets were readjusted to more realistic levels. Within the plan, the following targets were envisaged:

- A 10.4 per cent annual GDP growth rate.
- An increase of the productive sector's share in GDP from 38.8 per cent in 1980 to 44.8 per cent in 1985.
- A rise by 7 per cent per annum of value in agriculture.

- A rise by 17 per cent per annum of value in industry.
- An increase in domestic revenues to cover at least current expenditures. The ratio of domestic revenues to GDP was set to rise from 22.2 per cent in 1982 to 35.4 per cent in 1985.
- Imports of goods and services to grow only by 11.9 per cent annually, to a forecasted JD 653 million in 1985; a planned growth table of 19.8 per cent was established for exports.

According to the plan, total investment expenditure would amount to JD 3.3 billion during 1981-85, of which 53.4 per cent was earmarked for production sectors and tourism and the remainder for infrastructure and social services. As the plan was obviously founded on an assumption of a high degree of uncertainty, which is the continuation of Arab financial support, the unsatisfying consequences can be easily predicted. The few months after the plan was published in Spring 1982 marked the beginning of Jordan's economic recession, and the starting point of an accumulation of unfavourable factors which prevented the plan from achieving its main targets. Capital inflows from abroad declined. Arab aid resources were cut too. Income from phosphate decreased more than expected. The importance of Iraq as an export market declined and Jordan's outstanding debt was aggravated. Thus by 1983, the recession in the region had filtered through to Jordan and it was clear that the 1981-85 Plan's target of 11 per cent growth in the real value of GDP was hopelessly over-ambitious. In fact, the growth had slowed down considerably and was running at around 4 per cent a year, well below the target rate of growth (National Westminster Bank, *Country Report: Jordan*, 1984). Unlike official Jordanian sources who considered such achievements as a good performance compared to those of industrialized and developing countries, one can consider such claims as unconvincing if the political as well as the economic uncertainties from which Jordan in particular suffers are considered.

Finally, the new Five-Year Plan (1986-1990) was published in late 1986. The plan has been conceived after a very wide process of consultation. It attempts to set more realistic and achievable development targets, moving from concentration on large projects, which have been a feature of previous plans, and focusing instead on agriculture and smaller scale industrial developments. The plan targets an average 5 per cent annual growth in GDP, rising gradually from 3 per cent in 1986 to 6 per cent by 1990. It seeks to achieve a better balance between total consumption and income, with consumption targetted to grow at only 4 per cent a year, and to improve the performance on the current budget from a deficit of JD 107.5 million in 1985 to a surplus of JD 47 million at current prices in 1990. The plan forecasts a rise in exports of 8.3 per cent a year; imports will be controlled to ensure an annual maximum increase of 2.8 per cent for imports of goods and 3.6 per cent for services. Total investment is set at JD 3.175 million, slightly less than investment under the 1981-85 Plan (though many major projects scheduled for 1981-85 were postponed in the wake of the oil price fall). This is in addition to a JD 362.5 million public investment programme which has been drawn up for the Occupied Territories of the West Bank, for the first time since it was taken over by Israel in 1967 (In 1988 this programme was cancelled. See subsection 5.2.1. above).

In terms of spending allocation, top priority is being given to housing and transportation (30 per cent of total investment) and within the productive sector to manufacturing and mining, agriculture, water and irrigation and energy and resources (together accounting for 39 per cent of total planned spending). Perhaps the most important aim of the plan is to combat the growing rate of unemployment. To that end the plan envisages the creation of 97,000 new jobs in order to keep the problem at least at a manageable level.

A conference on this plan was held in November 1986 in Amman involving representatives of worldwide funding agencies. The plan has been criticised by representatives of Arab aid funds as being over-ambitious in terms of its economic objectives. It is said that the projections for the balance of payments are unrealistic and that the economy's tendency towards over-consumption has made it unusually and dangerously dependent on foreign financing. Although the period of the plan has not completely ended so as to be evaluated*, the performance of the economy during the first two years of it (presented in different

* An analysis of the current crisis of the Jordanian economy, however, will be provided in the next chapter.

places in this chapter) confirms the idea that the plan's overall economic targets are over-ambitious.

From the previous review, however, it clearly appears that Jordan is still suffering from the absence of an appropriate development planning approach. This of course is due to a set of unfavourable factors, mainly the problems of government and administration. The government system lacks an explicit policy in development administration. On the one hand this system is characterized by too many institutions and agencies with overlapping duties and responsibilities and duplication in laws and bye-laws that regulate their functions. On the other hand, there is centralization of authority and decision-making at the top with no delegation of authority from the centre and between the centre and the regions (*The Five-Year Plan* (1981-1985), p.20).

Accordingly, the responsibility for sectoral planning is still not fully defined and the relationship between the Ministry of Planning and the various ministries and institutions engaged in the planning process is characterized by overlapping and a lack of clarity. In addition, there are overlapping duties, responsibilities and authorities among the various ministries and institutions in the same sector as well as disparities in the capacity for planning and implementation among the sectors. It is worth mentioning that the ability of the private sector and of autonomous public institutions in the planning and implementation of development projects exceeds that of the government ministries due to the flexibility they enjoy, particularly salary scales and decision making. Another problem is that the planning process is affected by the serious deficiencies in information and statistics due to the absence of a national information storage and retrieval system capable of providing systematic and precise statistics. While the deficiency applies to various activities, it stands out with greater intensity in the sectors of water, energy, agriculture and natural resources which is of great importance to economic development. There is also a dearth of comprehensive statistics on national accounts in constant prices, production and price indices, employment, wage levels and income distribution. In addition, published data needs to be re-examined and up-dated in the interest of greater precision.

5.3.10 Imbalanced Socio-Economic Development Achievements

Despite all the above, throughout its development drive, Jordan has achieved remarkable socio-economic progress reflected in the provision of social services to meet the basic human needs of the population in the fields of health, education, housing, etc. Nevertheless, many of the unfavourable characteristics of Jordanian society, as well as many of its problems which arise from both external and internal factors, still exist. Social services in Jordan are rudimentary, health treatment is expensive and out of reach of the poor, and there is no unemployment or other social security benefits for most people.

In addition to problems of urbanization and geographical distribution of population, Jordan is affected by the existence of different social groups with differing tribal and political loyalties. With this regard, considerations were given to individual tribes with traditionally varying loyalties to the royal family, and to the Palestinian population with its doubtful loyalty to the regime as well as the question of its location. Accordingly, although many programmes were designed to balance differences in development, socio-economic indicators show obvious disparities in regional distribution development gains.

Apart from the Palestinian camps, rural communities, which constitute 39 per cent of Jordan's population, are facing a variety of problems, including low standards of living, a lack of basic social services, migration to the cities and in some areas a gradual decline in agricultural production.

As for income distribution, there is no up-to-date data on the distribution of national income among various segments of the population. However, official sources still confirm the existence of discrepancies in per capita income in the various regions, giving the example that family income in the Amman-Zarqa region is higher than family income in the other regions (*The Five Year Plan* (1981-1985), p.20). Socio-economic indicators also show an unequitable distribution of social, health and educational services among the various regions.

Unlike women in urban communities, Jordanian women in rural communities, for example, are facing a number of problems such as illiteracy, a lack of awareness of the proper methods of child-rearing and the benefits of home economies, a low level of productive skills, and a shortage of effective women's organisations capable of developing the ability of women to solve their problems.

Despite the substantial progress in the field of education that Jordan has witnessed during the past few decades, the ratio of illiteracy in rural areas is still rather high, especially among women. Recent results showed that in rural areas the illiteracy rate is 48.6 per cent of which 29.9 per cent is for males and 67.6 per cent for females, whereas the rate is significantly lower in urban areas (13.3 per cent for males and 37.8 per cent for females) (*The Five-Year Plan* (1986-1990), p.197).

As far as medical services in Jordan are concerned, the health sector in general is still suffering from many problems, such as:

- a shortage of technical staff in ancillary medical services;
- a low ratio of hospital beds to population (18.8 beds per 10,000 persons)*;
- insufficiency of existing hospitals in the different regions of the country and their inability to meet the needs of the areas which they serve;
- random distribution of medical clinics and the shortage of integrated medical centres in the rural areas.

The inability of medical services to cover all regions of the country will of course affect the rural and the poorer groups of population rather than the others.

On the whole, the above aspects of socio-economic development in Jordan reflect the existence of accumulated problems which can only be solved after a great deal of time and effort.

5.3.11 Western-Oriented Framework for Development

It is very well known that the process of development will not achieve its targets successfully and always will be tinged with weakness if it is pursued without the full participation and the sense of belonging of the people. However, this

* The ratio in other Arab countries is higher; in Egypt it amounted to 21, while in Kuwait it reached 40. In a developed country like West Germany the ratio is 118 but in the United States it is only 64.(see The Five-Year Plan (1986-1990). p.216

only can be achieved through acquiring a framework within which all members of the society can be incorporated.

Thus, this framework should be based on the belief of the community so as to include its ideological, cultural and spiritual features. This can help to mobilize all forces and capabilities, both quickly and systematically which in turn can help to solve all political, economic and social problems of all members of the society.

As far as the Jordanian experience is concerned, the Jordanian government, like those of most Arab countries, has confined its sources of inspiration and admiration to the western model of life and progress. Hence, the framework it has adopted for its development process is a western-oriented one.

Although the majority of the population are Muslims (about 95 per cent, no effort has been made on the part of the Government to preach Islam or to apply the Shariah, and Islam has no significant impact on the functioning of the economy. The development of Muslim society, in the Islamic sense, is therefore due to the Islamic movement's activities. It is believed among the people of the Islamic movement in Jordan, like elsewhere, that a healthy and growing economy is assured only if individuals and the society operate in accordance with the ordinances of Islam, and that it is noncompliance with these rules that leads to socio-economic problems.

However, similar to most Arab governments, in its interpretation of the failure in achieving an actual, comprehensive and balanced socio-economic development, the Jordanian government has never allowed itself to think of any alternative method to the secular and western form it has adopted. This despite the existence of a ready-made alternative which is still very much alive both spiritually and ideologically in the conscience of Muslims, even if it has not been given the opportunity to be completely and widely applied. That is the Muslim approach and the economic system in Islam, from which Islamic finance in Jordan (the case study of this thesis) is assumed to be derived, and according to which it is assumed to be operating.

Chapter VI

The Financial and Banking System in Jordan

6.1 Introduction

The purpose of this chapter is to provide an analysis of the financial and banking system in Jordan. This chapter is divided into seven major sections. Following this introduction, Section 2 will provide a brief review of central banking in Jordan. While commercial banks will be examined in Section 3, the specialized credit institutions will be the focus of Section 4. Section 5 will examine other banking institutions, including the financial companies and the real estate institutions. In Section 6, the non-financial institutions will briefly be highlighted. An assessment of the current financial and economic crisis of Jordan will be provided by the last section. It should be noted, however, that Islamic banking will not be dealt with in this chapter as it will be the main concern of the three following chapters.

6.2 Central Banking in Jordan

6.2.1 The Evolution of Central Banking

Central banking in Jordan has evolved over a long period of time. Several currencies and coins such as Sterling, Egyptian pounds and others were used in Jordan as a medium of exchange up to 1949 when the Jordan Currency Board (JCB) was established by the Temporary Law of Jordanian Currency, No. 35, 1949. The Jordanian dinar was set as the monetary unit of Jordan. This was only in July 1950. The Jordanian Currency Board, however, was restricted to maintaining 100 per cent Sterling asset backing for local currency issue. It had no role in controlling the money supply, in directing credit or in bank supervision. These tasks were only undertaken in Jordan when the Jordanian Central Bank was later established.

In 1959, the Central Bank of Jordan (CBJ) was established by the first central banking law in Jordan (Law No. 4, 1959).

However, it was only in October 1964 that the CBJ commenced business. Although, the law establishing the CBJ emphasised the conventional responsibilities of the Central Bank for the regulation of currency issuance, maintaining a stable exchange rate and internal monetary stability, regulating banking activities and acting as a banker to the Government, it was at best vague and badly written. No reference was made to economic growth or development among its objectives in sharp contrast to the objectives of the central banks of most other developing countries.

Thus, at this stage, the competence of the CBJ in pursuing monetary policy was explicitly limited, as it lacked the ability to control the supply of money and credit in Jordan, the *raison d'etre* of a central bank (Khatib, 1987).

This policy continued until 1967, when a series of legislative changes took place. The objectives of the CBJ were identified and the promotion of economic development was added as one of them. In 1971, a new central banking law (Law No. 23, 1971) was issued replacing the 1959 and the 1966 legislations. It was stated in this law that the objectives of the central bank were to maintain monetary stability in the country and to ensure the convertability of the currency of the country in accordance with the general economic policy of the Government.

6.2.2 Effectiveness of Monetary Policy

Jordan is still suffering from the economic recession that started in 1983, as shown in the previous chapter. Since monetary policy is not determined in a vacuum, questions concerning the extent to which the CBJ is able to achieve the above objective have recently been widely raised.

Accordingly, one of the most important indicators to be investigated is the extent to which the monetary authorities were able to exert influence over the money supply in the country.

It is worth mentioning here that money supply is determined by two fundamental variables; the monetary base, or "high powered money", and a money supply multiplier which expresses the ratio of money supply to the monetary base. In this regard, two monetary aggregates of narrowly defined money (M1) and broadly defined money (M2) are widely used to represent money supply*

In recent years, economic commentators have given increasing publicity to the idea of controlling the fluctuations of monetary aggregates rather than other targets. Therefore, the literature has placed more attention on the concept of the monetary base. It forms the foundation on which the superstructure of credit and money are built in a modern economy (Thomas, 1979).

As far as the Jordanian experience is concerned, Table 6.1, which includes some selective years, shows that money supply has increased substantially since the establishment of the Central Bank in 1964. Within 20 years, currency with the public increased 23 times when it increased from only JD 23.0 million in 1964 to JD 530.5 million in 1984. In 1986 it accounted for 61.2 per cent of the total money supply measured by M1.

What clearly reflects the significance of the growth of money in Jordan is the ratio of money supply to GNP. If money supply is expressed by M2, this ratio has significantly increased from only 33.4 per cent in 1964 to 78.7 per cent and 123.7 per cent in 1974 and 1986 respectively. This behaviour indicates that there was a switch out of currency and demand deposits into saving and time deposits, which is also reflected in the rise of quasi-money proportion to M1 since the mid-1970s. This proportion increased from only 27.8 per cent in 1974 to 142.1 per cent in 1986 (Table 6.1).

As for the elements which govern the money supply, unfortunately for Jordan, they are always out of the Central Bank's control. According to Mousa† (1981),

> "all factors that determine the monetary base in Jordan are outside the actual control of the monetary authority. The major proportion of foreign currency balances is realized through foreign aid and remittances from Jordanians working abroad and the Central

* They are generally defined as follows:

M1 = currency and coin held by the public outside the banks and demand deposits.

M2 = M1 + saving and time deposits.

† The chairman of the Monetary Affairs Department at the Central Bank of Jordan.

Table 6.1 : Some indicators of money supply in Jordan (selective years) - JD million & percentages.

Year	Currency		Demand deposits		M1	Quasi money*	M2	G.N.P	M1/G.N.P	Quasi/G.N.P	M2/G.N.P	Quasi/M1
	Volume	As % of M1	Volume	As % of M1								
1964	23.0	57.9	16.7	42.1	39.7	13.8	53.6	160.6	23.9	8.6	33.4	34.8
1974	115.5	67.1	56.5	32.9	172.0	47.8	219.8	279.3	61.5	17.1	78.7	27.8
1984	530.5	60.4	347.9	39.6	878.4	879.3	1757.7	1854.5	46.6	47.4	93.2	100.1
1986	655.8	61.2	379.9	38.8	979.8	1392.4	2372.2	1917.4	51.1	72.6	123.7	142.1

* Defined as time & saving deposits

Source : Central Bank of Jordan, *Yearly Statistical Series (sp. issue)*, 1984, *Monthly Statistical Bulletin*, Vol. 24, No.1, 1988 (Author's calculations).

Bank has no role in influencing either of them. This also applies to the public debt and government deposits as the former is determined by the deficit of the state budget and the latter result from the surplus of public revenues over public expenditure" (pp.10-11).

From the above considerations, Mousa (1981) has concluded that,

"the control on the monetary base as well as stability in its growth is difficult, if not impossible, to achieve" (p.11).

Relevant to the above argument are the monetary policy instruments through which central banks traditionally attempt to exercise control over the money supply. For Jordan, these instruments may be quite explicitly described as ineffective. Historically, the monetary weapons to which the Central Bank of Jordan has resorted are restricted to the bank rate, the reserve ratio, the liquidity ratio and the credit control. According to Mousa (1981), these weapons will remain the reliable ones for the near future. This is mainly due to the limitation of the financial market in Jordan which restricts the possibility of developing open market operations.

Having examined the statistical relationship between money supply (M1 and M2) and the above instruments of the monetary policy, it was found that this relationship is undoubtedly weak. The correlation coefficient between money supply on one hand, and the bank rate as well as the liquidity ratio on the other, was 0.38 and 0.37 respectively. The correlation coefficient between money supply and reserve ratio also was 0.81. Moreover, in contrast with what is stated in theory regarding the control of money supply, it was disclosed that the relationship between money supply and the bank rate was positive (Mousa, 1981, p.12).

Accordingly, it can be said that both the bank rate and reserves ratios as instruments of monetary policy have exercised no influence to restrain the growth of liquidity in Jordan. This is mainly due to the high liquidity of banks which always preserve an excess over the required liquidity. (This point will be dealt with in more detail in the next section of this chapter.) The conclusion of the previous argument has recently been emphasized by Khatib (1987).

Having analyzed the evaluation of Jordan's monetary and financial system prior and after the establishment of CBJ, and investigated the effectiveness of instruments of the monetary policy, Khatib has concluded that:

"The Central Bank was not successful in adopting an appropriate monetary policy which could positively affect the assets portfolio behaviour of the financial institution in favour of financing economic development in Jordan" (p.118).

He also stressed that,

"in the absence of any long-term target for the CBJ and the ineffectiveness of most of the traditional instruments (i.e. open market operations, the variable reserve ratio and the bank rate), the only instrument found to be appropriate for the CBJ is to rely on a credit control policy. Hence credit control policy lies at the heart of monetary policy" (p.107).

6.3 Commercial Banks in Jordan

6.3.1 The Introduction of Commercial Banking

Commercial banking in Jordan is a relatively recent development which goes back no further than the mid-1920s. The Anglo-French owned Ottoman Bank started operations, opening a branch in Amman, in 1925. The Ottoman Bank acted as fiscal agent for the Jordanian government, it did not, however, have a note issue (al-Salim, 1986).

The Arab Bank, which was established in Jerusalem in 1930 and moved its headquarters to Amman after the 1948 War, was the first locally based commercial bank to start business in Jordan. By the 1960s the Arab Bank had become the largest bank in the Arab Middle East in terms of deposits and lending, and even the loss of the West Bank branches (after the 1967 War) did not upset its position (Wilson, 1983, p.47).

The British Bank of the Middle East was established in Amman in 1949. That was followed by the Jordan National Bank in 1956. In 1960, two new local banks were established; the Bank of Jordan and the Cairo-Amman Bank. Thereafter, more local and foreign banks were established, bringing the total number of commercial banks operating in the country to 17 by the end of 1987. Of these, ten are Jordanian, three Arab and four foreign. There are also two investment banks; the Jordan Islamic Bank for Finance and Investment and the Arab Jordanian Investment Bank which are metaphorically adjoined to commercial banks (See Table 6.2).

Table 6.2: **Commercial banks* in Jordan, 1987.**

Name of Bank	Establishment Year	No. of Branches
Jordanian Banks:		
Arab Bank Ltd	1930	24
Jordan National Bank	1956	30
Bank of Jordan	1960	26
Cairo-Amman Bank	1960	15
Jordan-Kuwait Bank	1977	14
Jordan and Gulf Bank	1978	21
Petra Bank	1978	25
Arab Jordan Investment Bank	1978	2
Jordan Islamic Bank	1979	13
Syria-Jordan Bank	1980	1
Total		171
Foreign Banks:		
British Bank of the Middle East	1949	5
Arab Land Bank (Egypt)	1951	9
Rafidain Bank (Iraq)	1957	4
Grindlays Bank (UK)	1959	12
Bank al Hashrek (Lebanon)	1972	4
Citi Bank (USA)	1975	1
B.C.C.I** (Luxembourg)	1975	3
Total		38
The grand total of branches		209***

* Including the Jordan Islamic Bank.

** Bank of Credit and Commerce International.

*** If the number of the Housing Bank branch of 81 is added the total will be 290.

Source : The Central Bank of Jordan, *The Annual Report*, 1987. The Association of Banks in Jordan, *The Annual Report*, 1987.

After 1980, the establishment of new banks was banned*by the Central Bank but the number of branches continues to grow. It increased from 71 in 1975 to 209 in 1987. Most of this increase was in branches of Jordanian banks. By 1984, their number increased by 100 compared to an increase of only nine in the branches of foreign-owned banks. This, without doubt, was due to the Central Bank's policy of allowing the Jordanian banks to open branches in the capital city, Amman, and in larger cities, while preventing the foreign banks from doing so. While all foreign bank branches are located in Amman, the latter accommodates more than 52 per cent of commercial bank branches of the country in 1987. In January 1984, the Central Bank announced measures to 'Jordanize' foreign banks operating in Amman. They were given three (later extended to five) years to comply with regulations requiring that 51 per cent of their equity be held by Jordanian nationals. The only foreign bank to respond was the Arab Land Bank. However, in April 1985, the then new Government abandoned the regulation, though this did not affect another requirement for all banks to raise their capital from JD 3 million to JD 5 million in line with local commercial banks, as will be shown later. The Chase Manhattan Bank decided to withdraw from Jordan in 1986, rather than to comply with the directive to increase the capital. In February 1984, new Central Bank regulations stated that all banks must invest at least 4 per cent of their total deposits either in government bonds or in government-guaranteed public corporation bonds, together with a further 4 per cent in treasury bills. In addition, banks must also now invest at least 15 per cent, but not more than 75 per cent, of paid-up capital and domestic reserves in public shares (information is quoted from the Central Bank's legislations).

In January 1986, the Government lifted most of the restrictions preventing non-Jordanian Arabs from investing in the Jordanian economy. The only restriction to remain in force was that permitting a 49 per cent maximum shareholding for non-Jordanian Arabs in retail trade, banking, finance and insurance companies.

* Currently this ban seems to be at an end as Jordan witnesses the emergence of new banks; while the Jordan Investment and Finance Corporation was renamed The Jordan Investment and Finance Bank on 1st. September 1989. the problem of the collapsed Islamic Investment House has ended with the establishment of the National Islamic Bank in August 1989 (see Chapter 9).

The change of policy was seen as an attempt to attract private capital to Jordan to offset the decline in the Arab aid.

In November 1986, by mutual agreement with Israel, a branch of the Jordan-based Cairo-Amman Bank was opened at Nablus, in the West Bank, to provide financial services for the Palestinian community. Although the Bank has opened two other branches in both Hebron and Ramallah, its operators are strictly subject to measures and restrictions imposed by the Israeli authorities. Such restrictions have made it difficult for the Bank to be more than a money changer.

6.3.2 Sources of Commercial Bank Funds

The commercial banks' task as intermediaries in the financial market is to mobilize resources from all sources and to distribute them among various sectors of the economy. They attract deposits from different types of customers and utilize these deposits as well as their own capital, retained profits and resources for financing.

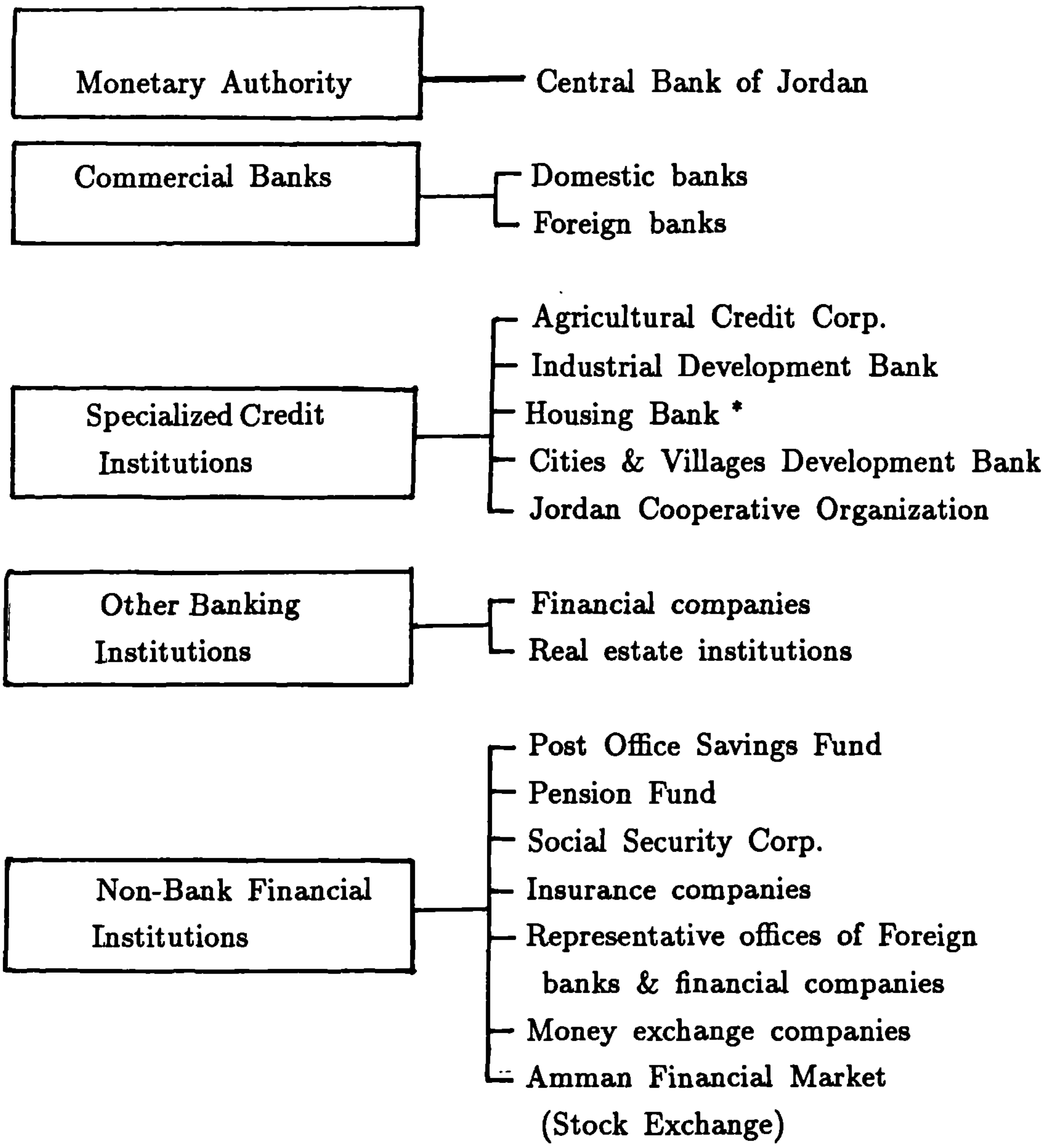
The main sources of funds for commercial banks in Jordan, as they appear in their consolidated balance sheet, can be examined as follows:

1) Capital and reserves:-

According to the Banking Law No.4 of 1971, all licensed banks in Jordan are required to maintain a working capital of not less than JD 500,000 at any time. During the period 1971-84, the Central Bank has increased this amount at different times. By the end of 1985, the Central Bank required the commercial banks to maintain a minimum capital of JD 5million (CBJ, *The Financial and Banking Structure of Jordan*, 1986, p.18). The development of the liabilities of commercial banks in Jordan in the last year is portrayed in Table 6.3.a and Table 6.3.b. It is shown that their capital increased from JD 25.5 million in 1977 to JD 80.2 million and JD 103.5 million in 1982 and 1987 respectively. However, the relative importance of bank capital to bank liabilities declined from 6 per cent in 1977 to 5.2 per cent and 3.6 per cent in 1982 and 1987 respectively.

According to Jordanian banking law, every licensed bank must transfer 10 per cent of its annual net profit realised in Jordan to its stationary reserve account

Chart 6.1 : Structure of the financial system in Jordan.



* For purposes of analysis, the Housing Bank is considered a part of the commercial banking sector.

Source : Derived from The Central Bank of Jordan, *Annual Report*, 1987.

Table 6.3.a : The liabilities of commercial banks in Jordan, 1977-1987 (JD million).

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Capital employed :											
Capital	25.5	43.1	51.5	55.3	62.8	80.2	81.1	83.2	100.7	103.3	103.5
Reserves	7.2	11.7	16.4	21.5	28.9	51.0	58.2	69.7	63.7	74.3	82.2
Deposits :											
Private sector deposits	267.4	364.6	465.4	580.6	706.4	883.4	1035.4	1169.8	1274.4	1425.0	1663.9
Deposits of non-residents	18.9	47.5	67.1	133.3	143.5	171.6	216.7	276.9	294.3	305.5	300.8
Government deposits	21.1	24.3	43.8	63.6	77.2	78.3	97.2	111.9	121.3	156.2	127.3
Public deposits	7.4	12.1	14.8	31.0	50.5	36.2	48.5	44.5	57.2	59.5	50.3
Deposits of local banks	21.8	50.2	54.7	64.3	87.0	46.2	68.5	71.6	125.1	130.8	133.2
Deposits from foreign banks	2.3	12.5	16.6	15.0	33.9	29.2	30.0	36.8	40.3	39.3	71.8
Borrowing from :											
foreign banks	-	-	-	-	-	0.3	0.9	2.0	3.0	3.3	9.0
local & central bank	6.6	8.7	7.2	10.0	14.7	39.1	64.7	89.1	103.8	118.8	112.6
Other liabilities :	44.3	62.4	84.2	95.9	125.8	138.1	161.1	182.5	208.3	218.9	243.9
Total liabilities :	422.5	637.1	823.7	1070.5	1330.7	1553.5	1863.3	2136.0	2392.0	2634.8	2898.5

Source : Central Bank of Jordan, *Yearly Statistical Series (1964-1983) (special issue No. 20)*; Central Bank of Jordan, *Monthly Statistical Bulletin*, Vol. 24, No. 1, 1988.

Table 6.3.b : The liabilities of commercial banks in Jordan, 1977-1987 (percentage).

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Capital employed :											
Capital	6.0	6.8	6.2	5.2	4.7	5.2	4.3	3.8	4.2	3.9	3.6
Reserves	1.7	1.8	2.0	2.0	2.1	3.2	3.1	3.2	2.7	2.8	2.8
Deposits :											
Private sector deposits	63.3	57.2	56.5	54.2	53.1	56.1	55.6	55.7	53.3	54.1	57.4
Deposits of non-residents	4.5	7.5	8.1	12.3	10.3	11.0	11.6	13.0	12.3	11.6	10.4
Government deposits	5.0	3.8	5.6	5.9	5.2	5.0	5.2	5.2	5.1	5.9	4.4
Public deposits	1.7	1.9	1.8	2.8	3.8	2.8	2.6	2.0	2.4	2.3	1.7
Deposits of local banks	5.2	7.9	6.6	6.1	6.5	3.0	3.8	3.2	5.2	5.0	4.5
Deposits from foreign banks	0.5	2.0	2.0	1.5	2.6	1.9	1.7	1.7	1.8	1.6	2.5
Borrowing from :											
foreign banks	-	-	-	-	-	0.01	0.04	0.09	0.1	0.1	0.3
local & central bank	1.6	1.4	0.9	0.9	1.1	2.5	3.5	4.0	4.8	4.5	4.3
Other liabilities :	10.5	9.8	10.3	9.0	9.5	9.0	8.7	8.0	8.7	8.3	8.4
Total liabilities :	100	100	100	100	100	100	100	100	100	100	100

Source : Calculated from Table 6.3.a.

until this reserve is equal to its working capital (Law No. 24, Article 13.). As is shown in the tables, reserves accounted for 3.2 per cent of total commercial bank liabilities in 1984 compared to 1.7 per cent in 1977. But in 1986 this ratio declined to 2.8 per cent.

2) Bank deposits:-

a) Deposit trends:

The distribution of commercial bank deposits in Jordan, given in Tables 6.3.a and b, shows that the private sector deposits within the country (resident) are the main source of commercial bank funds. It enjoyed the lion's share over the last decade. In 1977 it was JD 267.4 million, then it increased to JD 883.4 million in 1982, and finally reached JD 1663.9 million in 1987. Since 1980, its share in total liabilities has almost been stable around 53-57.5 per cent with no marked trends.

The increase of private sector deposits can be ascribed to a number of factors including the growth of the national income (GNP); the expansion of bank branches and the establishment of the Jordan Islamic Bank operating according to Islamic *Shariah.* Thus it was possible for those Muslims who refrained from dealing with commercial banks due to the prohibition of interest in Islam to deposit their money with the Islamic Bank. In 1985, the Jordan Islamic Bank was classified as the fifth bank in the country according to deposit size and the second according to growth rate of deposits. In recent years, its position has further improved as will be shown later.

The share of non-residents' deposits in total liablities grew most rapidly in the 1970s. This clearly reflected the boom in oil-exporting countries' income during that period.

In the 1980s the share stabilized at just over one tenth of total liabilities as Table 6.3.b shows.

The distribution of deposits also indicates the insignificance of the relative importance of government and public deposits. In 1987, together they accounted for only 6.1 per cent of total liabilities.

Deposits from both local and foreign banks are also insignificant. While the share of the former amounted to 4.5 per cent of total liabilities in 1987, it only reached 2.5 per cent for the latter during the same year. It is worth noting here that this trend indicates the absence of a developed inter-bank market in Jordan on one hand, and the insignificant role of foreign banks in serving the local population on the other (See Wilson, 1987a).

In 1987, 73.9 per cent of total liabilities imputed to deposits excluding bank deposits. If the latter is added, the contribution of total deposits to total liabilities in the same year will be 80.9 per cent (Calculated from Table 6.3.b.).

b) Types of deposits:

Commercial banks in Jordan hold three major types of deposits which can be distinguished as follows:

i) Demand deposits:

Demand deposits are the deposits against which funds are available to the customer at any time. They require no advance notice of withdrawal and are usually drawn against writing cheques. In Jordan, demand deposits are entitled to interest rate payments. This rate was set at 5 per cent in 1977, but it was gradually reduced until it reached 2 per cent in 1987.

Until the end of the 1970s, demand deposits were the most common type of deposits in Jordan. In 1977, they accounted for 52.7 per cent of total deposits, compared to 27.7 per cent and 17.7 per cent in 1983 and 1987 respectively.

This sharp decline in the share of demand deposits to total deposits could be explained as the start of a new trend in the composition of bank deposits in Jordan, reflecting a switch from demand deposits to term deposits as a result of low inflation. In 1985, the inflation rate stood at 3 per cent but a negative rate has been predicted for 1987 reflecting the continuation of the economic recession in the country.

ii) Time deposits:

In Jordanian banks time deposits are classified into time deposits due on a fixed date and time deposits subject to notice. The latter is considered to be less flexible than the former. Total time deposits increased significantly from JD 86.9 million (27.6 per cent of total deposits) in 1977 to JD 794.1 million (56.8 per cent of total deposits) in 1987. The major contribution in total time deposits is from time deposits due on a fixed date. In 1987, they accounted for 62.3 per cent of total deposits (Table 6.4). By having different accounts of time deposits opened at different periods with different due dates depositors may ensure a liquid cash flow position with regard to their bank holdings. This has become common practice in Jordan with the banking customers aiming to achieve both flexibility and the maximum possible returns on their assets. Less flexible are time deposits subject to notice: although the notice periods of 90 or 180 days are shorter than the periods for fixed time deposits, usually at least a year, the need always to give notice reduces the liquidity of the deposit. Also, interest rates on time deposits subject to notice are usually 0.25 per cent lower than those on fixed time deposits. For these reasons, time deposits subject to notice are the least popular type of deposit, as Table 6.4 shows.

iii) Savings deposits:

A saving deposit is an interest paying account used to safekeep and accumulate funds. It is generally designed for small savers who pay in a specified sum each month on a term basis. Interest rates on saving deposits are at least 2 per cent higher than those on demand deposits, but 1.5 per cent less than those on fixed time deposits. Funds can be withdrawn on demand, but the depositor has a continuing obligation to pay regular payments.

Due to the rapid expansion in bank branches, as well as the improvement of banking habits among people in Jordan, saving deposits held by commercial banks increased over the second half of both the 1960s and the 1970s, according to the Central Bank data. However, over the last decade, the relative importance of saving deposits has declined from 19.7 per cent of total deposits in 1977 to 13.2 per cent in 1987, as shown in Table 6.4. Partially this is due to the low premium paid for saving deposits compared to the premium paid for time deposits and successfully attracted workers' remittances and non-resident bank deposits.

Table 6.4 : Commercial banks* deposits by types in Jordan, 1977-1987 (JD million & percentages).

Year	Demand deposits		Time deposits				Saving deposits		Total deposits
			Due on fixed date		Subject to notice				
	Volume	%**	Volume	%	Volume	%	Volume	%	
1977	165.7	52.7	66.4	21.1	20.5	6.5	61.8	19.7	314.8
1978	172.5	38.5	138.6	30.9	52.0	11.6	85.0	19.0	448.5
1979	213.1	35.9	205.6	34.7	65.3	11.0	109.1	18.4	593.1
1980	288.1	35.6	297.1	36.7	94.2	11.7	129.1	16.0	808.5
1981	316.5	32.4	372.8	38.1	127.1	13.0	161.1	16.5	977.6
1982	354.5	30.3	491.8	42.0	134.7	11.5	188.4	16.1	1169.5
1983	387.7	27.7	677.1	48.4	118.0	8.4	215.9	15.4	1397.8
1984	409.6	25.5	824.5	51.4	133.7	8.3	235.1	14.7	1603.1
1985	374.6	21.4	992.9	56.9	140.9	8.0	238.7	13.7	1747.2
1986	370.6	19.1	1772.0	60.2	147.8	7.6	255.7	13.1	1946.2
1987	379.1	17.7	1336.3	62.3	142.9	6.7	283.3	13.2	2142.4

* Including housing bank and excluding bank deposits included in Table 6.3.a

** Its share in total deposits.

Source : Central Bank of Jordan, *Yearly Statistical Series (special issue)*, 1983, *Annual reports*, 1986,1987, *Monthly Statisical Bulletin*, Vol. 24, No. 1, 1988 (Author's calculations).

c) Borrowing:

Commercial banks' borrowing from the Central Bank and from local and foreign banks is of less significance. It only represented 4.6 per cent of total commercial bank liabilities in 1987 (Table 6.3.b). Most of this borrowing is from the Central Bank. Interbank borrowing in Jordan is still on a modest scale.

d) Other liabilities:

Other liabilities of commercial banks in Jordan increased from JD 44.3 million in 1977 to JD 243.9 million in 1987. In 1977, however, they accounted for 10.5

per cent of total liabilities against 8.4 per cent in 1987 (Tables 6.3.a and 6.3.b).

6.3.3 Uses of Commercial Bank Funds

The uses of commercial bank funds are expressed in the bank assets in the balance sheet of the bank. Basic assets can be classified into three major categories: liquid assets, lending and investment and other assets. For Jordan, each of these categories can be highlighted as follows:

1) Liquid assets:-

Liquid assets of commercial banks of Jordan include cash in Jordanian and foreign currencies, balances with the Central Bank and foreign and local banks, and government securities (treasury bills and government bonds). The asset deployment of commercial banks in Jordan is illustrated in Table 6.5. The most notable thing in the composition of liquid assets is the high proportion of balances with foreign banks which appear to be of considerable significance. They increased remarkably in relation to total assets in 1980 when their share amounted to 18.7 per cent and have remained at a high level (14.9 per cent in 1987). Banks argue that such an increase was likely due to two main factors. The first was the remarkable expansion in Jordanian imports during that period. Hence, for the banks to pay for these imports in foreign currency, they have to hold more of it in foreign banks. The second factor was that some foreign asset holding is precautionary given their foreign liabilities because of the increase in non-resident deposits. These deposits are in dinars, however, not in foreign currencies. In fact, this is not the whole story; a more likely cause of the increase in foreign asset holdings was the appreciation of the dollar, and record Eurodollar interest rates. Jordan's banks find foreign asset holding more profitable than deployment of funds domestically, although this phenomenon has been common for many Arab and European countries with relatively liberal foreign exchange regimes for capital movements (Wilson, 1987a).

The increase in balances with foreign banks adversely affected the holdings of government bonds and bills in 1980-81 and the banks' liquid reserves over the 1977-87 period. The share of the balance with the Central Bank in total assets declined from 14.9 per cent in 1977 to 5.8 per cent in 1987. However, this

Table 6.5.a : Commercial bank assets in Jordan, 1977-1987 (JD million).

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987*
Liquid assets :											
Cash	4.5	5.1	6.8	7.3	9.7	11.2	14.5	15.1	15.9	14.4	16.7
Balances with:											
Central Bank	63.2	76.6	95.1	109.6	106.6	107.9	121.4	124.2	148.6	168.0	167.6
local banks	17.5	49.0	51.2	64.9	92.9	51.7	93.0	91.4	144.2	167.1	184.4
foreign banks	34.9	72.3	76.4	201.1	227.4	245.9	283.5	311.2	367.9	385.4	430.9
Government bonds & bills	32.8	68.6	73.8	59.8	80.8	102.8	147.2	208.5	228.3	275.3	345.9
Investment & lending :											
Domestic investments	3.7	5.0	6.7	9.6	13.4	20.3	27.8	33.8	36.2	38.6	40.7
Investments abroad	1.8	2.3	3.3	3.7	4.8	8.8	19.0	16.3	14.3	16.1	17.9
Credit facilities :											
Loans and advances	200.6	259.4	371.1	459.7	572.9	711.2	843.1	972.8	1049.3	1155.0	1255.6
Bills discounted	43.5	73.4	93.9	104.2	148.4	175.9	187.8	212.0	225.1	240.4	257.4
Fixed assets :	7.5	9.1	13.3	17.9	27.1	38.9	46.5	57.9	66.8	68.0	73.9
Other assets :	12.5	16.3	31.9	32.2	46.7	78.9	79.5	92.8	95.3	106.0	107.7
Total assets :	422.5	637.1	823.7	1070.5	1330.7	1553.5	1863.3	2136.0	2392.0	2634.8	2898.5

* Preliminary

Source : As in Table 6.3.a.

Table 6.5.b : Commercial bank assets in Jordan, 1977-1987 (percentages).

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987*	Average %
Liquid assets :												
Cash	1.1	0.8	0.8	0.7	0.7	0.7	0.8	0.7	0.7	0.5	0.6	0.8
Balances with:												
Central Bank	14.9	12.0	11.5	10.3	8.0	7.0	6.5	5.8	6.3	6.5	5.8	7.9
local banks	4.1	7.7	6.2	6.1	7.0	3.3	5.0	4.0	6.0	6.4	6.4	5.7
foreign banks	8.3	11.4	9.3	18.7	17.1	15.8	15.2	14.6	15.3	14.6	14.9	14.1
Government bonds & bills	7.8	10.8	9.0	5.6	6.1	6.6	7.9	9.7	9.5	10.5	12.0	8.7
Investment & lending :												
Domestic investments	0.9	0.7	0.8	0.9	1.0	1.3	1.5	1.6	1.5	1.4	1.4	1.1
Investments abroad	0.4	0.4	0.4	0.3	0.4	0.6	1.0	0.8	0.6	0.6	0.6	0.6
Credit facilities :												
Loans and advances	45.9	40.7	45.1	43.0	43.1	45.8	45.2	45.6	43.9	43.8	43.2	44.1
Bills discounted	11.9	11.5	11.4	9.7	11.1	11.3	10.1	9.9	9.4	9.1	8.9	10.4
Fixed assets :	1.8	1.4	1.6	1.7	2.0	2.5	2.5	2.7	2.8	2.6	2.5	2.2
Other assets :	2.9	2.6	3.9	3.0	3.5	5.1	4.3	4.3	4.0	4.0	3.7	3.8
Total assets :	100	100	100	100	100	100	100	100	100	100	100	100

* Preliminary

Source : Calculated from Table 6.5.a

balance was always sufficient to meet the legal reserve requirement defined by the monetary authorities (10 per cent of the annual net profit of the bank).

Although, the Government provides facilities for cashing its securities (bonds and bills), commercial bank borrowing, through holding these securities has never been a significant source of government finance in Jordan. The average share of government securities during the 1977-87 period made up nearly 9 per cent of total commercial assets in Jordan (calculated from Table 6.5).

2) Lending and investments:-

Although commercial bank lending and investment in Jordan has increased over the 1977-87 period, investment within the country and abroad remained minimal. In 1987, this amounted to only JD 58.6 million or 1.8 per cent of total assets. This simply indicates the nature of commercial banks as not being investment-oriented. The significant increase, however, was in loans, advances and bills discounted. Table 6.5 shows that they represented the largest proportion of assets, constituting more than half of their total. With no marked trend, this amount remained at a high level and averaged 54.5 per cent over the 1977-87 period. The pattern of commercial bank lending and its impact on the economy will be examined in more detail later.

3) Fixed assets:-

Commercial bank fixed assets in Jordan have significantly increased from JD 7.5 million in 1977 to to JD 73 million in 1987. Its ratio to total assets amounted to 2.8 per cent in 1985. This means that commercial banks in Jordan have spent more and more on improvements to their own premises, and some of this spending is without doubt non-essential and extravagant.

4) Other assets:-

Other assets, including bills receivable, also increased from JD 12.5 million in 1977 to JD 107.7 million in 1987. In 1982 they accounted for 5.1 per cent of total assets.

6.3.4 The Sectoral Distribution of Commercial Bank Credit

To assess the impact of commercial bank activity on the economy it is necessary to examine the bank's pattern of lending; whether they extend long term funds to finance productive sectors in the economy or not. Complimentary to this is the following analysis of the sectoral distribution of the outstanding credit of commercial banks over the 1977-87 period illustrated in the Tables 6.6.a and 6.6.b.

1) Agriculture:-

In Jordan, commercial bank credit to agriculture was never of much significance. As is shown in Table 6.6.b. agriculture's share in total credit averaged 2.8 per cent during the 1977-87 period. The data also indicates that this share registered its lowest level in 1985 when it reached 2.1 per cent. Since the contribution of agriculture to GDP in this year amounted to 7.2 per cent and its contribution to exports amounted to 17.1 per cent, bank credit extended to this sector is remarkably insignificant.

According to bankers in Jordan, the small size of farm businesses and hence the difficulty and cost of administering farm loans and the lack of audited accounts are factors that make them reluctant to lend to farmers, especially when the latter cannot provide sufficient collateral. This is in addition to several serious and structural problems facing the agricultural sector in Jordan (mentioned earlier) including the low and irregular rainfall. This serious problem adds another crucial dimension to the smallness and instability of farm incomes which eventually make lending to farmers unattractive in Jordan.

This enables traditional lenders to offer their facilities exploiting farmers. According to Robins (1987), merchants and middlemen have dominated agriculture in Jordan. They supply seasonal credit to farmers and through high interest rates reinforce their state of indebtedness. Debts are usually paid in kind which results in low prices to farmers and consolidates the position of the middlemen as monopolists. Through this system, the middlemen prosper while the small farmers struggle to remain viable.

2) Mining:-

Table 6.6.a : Sectoral distribution of outstanding Commercial bank's credit in Jordan, 1977-1987 (JD million)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Agriculture	8.31	12.71	17.36	17.2	19.38	24.63	25.62	25.66	26.3	32.67	40.02
Mining	0.23	1.71	4.03	4.36	6.83	14.06	20.54	27.41	32.07	44.28	45.35
Manufacturing	26.6	36.58	56.48	68.72	82.44	98.53	118.43	142.37	157.16	176.74	175.31
Construction	65.78	100.54	151.0	180.76	201.03	216.75	271.34	324.05	331.57	353.68	358.25
Commerce & Trade	81.43	100.53	134.27	166.96	225.79	284.94	276.65	296.09	308.55	338.74	363.72
Transportation	11.08	8.38	13.04	14.48	23.28	32.88	50.48	58.48	64.02	49.36	38.80
Tourism	3.42	6.61	9.65	11.84	15.90	20.48	25.63	23.71	29.82	37.53	32.52
Financial institutions	0.86	1.18	4.76	8.70	9.36	19.90	25.63	29.60	29.93	29.20	31.45
Prof.& private indiv.	13.07	21.21	29.66	38.71	60.83	69.60	108.09	121.46	127.56	137.25	159.31
Other sectors	33.53	43.34	44.83	52.12	76.47	105.67	108,43	135.97	170.4	195.93	268.26
Total	244.05	332.80	465.05	563.85	721.31	887.17	1030.92	1184.82	1274.41	1395.41	1513.03

Source : As in Table 6.3.a.

Table 6.6.b : Sectoral distribution of outstanding commercial bank's credit in Jordan, 1977-1987 (percentage).

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	Av. %
Agriculture	3.4	3.8	3.7	3.0	2.7	2.8	2.5	2.2	2.1	2.3	2.6	2.8
Mining	0.09	0.5	0.8	0.8	0.9	1.6	2.0	2.3	2.5	3.2	3.6	1.6
Manufacturing	10.9	10.9	12.1	12.2	11.4	11.1	11.5	12.0	12.3	12.7	11.6	11.7
Construction	26.9	30.2	32.5	32.1	27.9	24.4	26.3	27.4	26.0	25.4	23.7	27.5
Commerce & Trade	33.4	30.3	28.9	29.6	31.3	32.1	26.8	25.0	24.2	24.3	24.0	28.2
Transportation	4.5	2.5	2.8	2.6	3.2	3.7	4.9	4.9	5.0	3.5	2.6	3.6
Tourism	1.4	1.9	2.1	2.1	2.2	2.3	2.5	2.0	2.3	2.7	2.1	2.1
Financial institutions	0.4	0.4	1.0	1.5	1.3	2.3	2.5	2.5	2.3	2.1	2.1	1.8
Prof.& private indiv.	5.3	6.4	6.4	6.9	8.5	7.5	10.5	10.2	10.0	9.8	10.5	8.4
Other sectors	13.8	13.1	9.7	9.2	10.6	11.9	10.5	11.5	13.3	14.0	17.8	12.3
Total	100	100	100	100	100	100	100	100	100	100	100	100

Source : Calculated from Table 6.6.a

Commercial bank credit extended to the mining sector in Jordan increased from JD 0.23 million (or 0.09 per cent of total credit) in 1977, to JD 45.35 million (or 3.0 per cent) in 1987. This increase in bank credit to this sector reflected the increase of phosphate and potash production.

3) Manufacturing:-

Commercial bank credit to the manufacturing sector in Jordan increased from JD 26.6million in 1977 to JD 98.5 million and JD 176.74 million in 1982 and 1986 respectively, but decreased to JD 175.30 million in 1987.

If manufacturing's share of bank credit is considered, this share has hardly changed from 10.9 per cent in 1977 to 11.1 per cent and 18.7 per cent in 1982 and 1986 respectively, but then declined to 11.6 per cent in 1987.

Despite the emphasis of Jordan's development plans on the manufacturing sector, commercial bank credit facilities to this sector are without doubt insufficient. The explanation provided by banks for such behaviour is that there are considerable risks in granting credit for industry or any of the productive sectors.

4) Construction:-

As is shown in Tables 6.6.a,b the building and construction sector which includes real estate, has occupied second place after trade relative to the proportion of commercial bank credit extended to this sector in 1979. In this year the proportion peaked at 32.5 per cent but then it declined and fluctuated until it reached 23.3 per cent in 1987. Of great significance to this proportioon is the contribution of the Housing Bank which amounted to JD 242.57 million or 67.7 per cent of total credit extended by commercial banks to this sector in 1987.

It is worth mentioning here, however, that the decline in bank credit to this sector generally reflected the decline in construction activities which has occured since the early 1980s, and still continues.

5) Commerce and trade:-

As is shown in Tables 6.6.a and b, credit to finance the trade sector (includes retail, wholesale and international trade) is clearly considered to be the favourite outlet for commercial banks in Jordan. Its total value amounted to JD 81.43 million (i.e. 33.4 per cent of total bank credit) in 1977. However, its share of total bank credit started to decline since 1975 when it was 40.6 per cent (as calculated from the CBJ data) until it reached 24 per cent in 1987. This may be ascribed to the shrinking demand for funds to finance both domestic and foreign trade, growth of which has been sluggish or has declined in recent years. The total value of imports declined from JD 1.14 billion in 1982 to JD 1.07 billion in 1984 and JD 850 million in 1986. Having examined the relationship between imports and trade finance in Jordan, Wilson (1987a) has pointed out,

> "It is difficult nevertheless to ascertain the direction of causation: whether the value of imports depends on the trade finance available, or if, with the banks so keen to finance imports, the volume of credit responds passively to the level of import demand." (p. 57)

6) Transportation:-

Commercial bank credit to the transportation sector increased from JD 11.08 million in 1977 to JD 64.02 million in 1985, but decreased to JD 38.8 million in 1987. Its share of total bank credit declined from 4.5 per cent in 1977 to 2.6 per cent in 1980, then increased to 5.0 per cent in 1985, but declined to 2.6 per cent in 1987. The economic slowdown in Jordan and other neighbouring countries started in 1983 and the political instability in the region (e.g. the Iraq-Iran War) are likely reasons for the depression of Jordan's transport industry and for the insignificance of bank credit directed to it.

7) Tourism:-

Commercial bank credit to tourism (including hotels, restaurants and national parks) in Jordan slightly increased from JD 3.42 million (or 1.4 per cent of total credit) in 1977 to JD 37.53 million (or 2.7 per cent) in 1986 but decreased to JD 32.52 million (or 2.1 per cent) in 1987. This low proportion of bank credit extended to the tourism sector reflects the modest scale and low growth of this industry in Jordan. Reasons which make it difficult for Jordan to be a potential leader in the industry would appear to be the country's climate, the political disturbance in the region and the loss of the West Bank (for the last two decades).

8) Financial institutions:-

Commercial bank credit to the financial institutions in Jordan increased from JD 0.858 million in 1977 to JD 29.93 million in 1985 but decreased to JD 29.2 million in 1986, and reached JD 31.45 million in 1987. The proportion they received of total bank credit increased from a very low 0.4 per cent in 1977 to a still low 2.3 per cent and 2.1 per cent in 1985 and 1987 respectively (Tables 6.6.a and b).

Although Jordan witnessed important financial and institutional innovations in the early 1980s, no major change has been realised in bank credit to financial institutions. These innovations were the introduction of financial intermediaries and the establishment of real estate and saving institutions; both will be highlighted later.

9) Professional and private individuals:-

One of the most significant proportions of commercial bank credit in Jordan is that which goes to professional and private individuals. As is shown in Tables 6.6.a and b, the total bank credit extended to this sector increased from JD 13.07 million (or 5.3 per cent of total bank credit) in 1977 to JD 108.9 million (or 10.5 per cent) in 1983 and reached JD 159.31 (or 10.5 per cent) in 1987. Most of this lending consists of personal loans given to satisfy personal needs (purchase a car or finance a wedding). Although commercial banks require security for lending to individuals, there is little risk to them as these borrowers have regular salaries paid into bank accounts, from which loan repayments can be deducted by direct debit.

10) Other sectors:-

Commercial bank credit to other sectors fluctuated over the considered period but generally it increased from JD 33.53 million in 1977 to JD 268.2 million in 1987. With this increase, the share in total credit is also increased from 13.8 per cent to 17.8 per cent respectively. The major contribution in this credit is that extended to municipalities and other corporations which accounted for 7.4 per cent and 13.5 per cent of total commerial bank credit in 1977 and 1987 respectively. This proportion, however, is still relatively insignificant.

6.3.5 The Role of Commercial Banks in Jordan Economic Development

From the previous review of the issues of commercial bank funds and their sectoral distribution in Jordan it can be concluded that:

a) From the sectoral distribution of commercial bank credits it is clear that commercial banks in Jordan have always supported the commercial loan theory according to which a bank should primarily provide short term loans aiming at a high degree of liquidity.

The historical experience of commercial banks in Jordan indicates that they have always maintained a high level of liquid assets holdings. In 1987, liquid assets accounted for 37.2 per cent of total assets against 41.4 per cent in 1980. As will be shown later, the average liquidity ratio of commercial banks in Jordan amounted to 52.7 per cent in 1987. This means that excess liquidity maintained by banks is 22.7 per cent since the legal liquidity ratio as defined by the Central Bank is 30 per cent. Holding such excess of liquidity undoubtedly has its negative impact on the economy. Simply, it deprives the productive sectors of funds required for economic development.

b) In allocating their funds, the first priority of commercial banks in Jordan is the commerce and trade sector. It has absorbed the lion's share of bank credit.

Given the fact that the bank operations in this sector are mostly concerned with the financing of important businesses, this will adversley affect the economy through increasing the balance of trade deficit of the country.

c) It can be seen from the sectoral distribution of bank credit that the second priority for commercial banks is the construction sector.

It has already been made clear that the major proportion of construction credit was contributed by the Housing Bank as stated earlier (In 1987, this amounted to 66.2 per cent of total credit extended to this sector by commercial banks.). However, it can be argued that injecting bank funds into real estate has clearly encouraged luxury urban house building rather than low cost and limited income housing. Such behaviour has forced up land prices and made it attractive to retain or to acquire land for speculative purposes.

d) In the above mentioned sectors, commercial banks are averse to lending to agriculture and industry (manufacturing and mining). As shown earlier, the proportion of credit extended to them during the last decade averaged only 2.8 per cent and 13.3 per cent of the total credit respectively. Banks claim, however, that the existence of specialized lending institutions and the high risks that are involved in financing long term agricultural and industrial projects are the main reasons behind their abstention.

e) According to a previous governor of the Central Bank of Jordan, Dr. Khalil al-Salim (1987), most lending extended to various economic sectors by commercial banks is given on the basis of solvency, credit worthiness and collateral strength of the entrepreneurs. Less consideration is given to the viability and profitability of investment projects as well as the economic development requirement and the public interest.

f) Despite the fact that commercial banks have confined their operations to short term loans as stated earlier, it can be argued that when examining the structure of the bank liabilities it seems to be possible for banks to make long-term loans. This can be illustrated as follows:

- The adequacy of the capital account of commercial banks in Jordan which averaged 7.4 per cent of total liabilities over the 1977-87 period, is an important factor to be considered. The equity capital as a safety fund for depositors and a hedge against insolvency must encourage banks to finance assets with a higher level of risk. The adequacy of the bank capital in Jordan can be understood in the light of the ratio of bank capital in some developed countries. While the bank capital in Jordan accounted for 8.4 per cent of total assets in 1982, the ratio in the same year amounted to 1.9 per cent, 2 per cent and 3.8 per cent in France, Japan and the United States respectively (Davies, 1987).
- The structure of the bank deposit in Jordan is also in favour of financing long-term projects. This can be illustrated by the following facts:
    - The upward trend of time deposits which have significantly increased over the last decade until it reached its peak in 1987 accounting for 68.9 per cent of total deposits as shown earlier.

- Saving deposits which at least can be allocated to finance medium-term loans, constitute an important source for commercial banks. They increased from only JD 61.8 million in 1977 to JD 283.3 million, although their ratio to total deposits declined from 19.7 per cent to 13.2 per cent respectively.

- Relative to the above is the demand deposits turn over, or what could be called the transactions velocity of demand deposits. The rate of demand deposits turnover can be calculated by dividing total debits against chequing accounts in a given year by average magnitude of demand deposits in that year. As Jordan has no reliable data covering bank debits, data concerning bank clearings can be used instead. However, the total amount of clearing cheques announced by the CBJ does not include two major factors; direct withdrawals by customers from the banks they deal with; and clearing cheques drawn on the same bank by its customers in dealings with each other. Thus, to accurately calculate the turnover of demand deposits in Jordan, the above two sources of withdrawals must be taken into consideration and their total amount is to be added to the bank clearings.

According to banking experts in Jordan, withdrawals of the above two sources can be estimated as 50 per cent of bank clearings (Interviews with officials of CBJ). In line with this, Table 6.7 shows the rate of turn over of commercial bank deposits in Jordan during the last decade. Though perhaps more than that of many LDCs, this rate has obviously been low. In 1977, it was 10.8 times per year, which means that depositors used to call for their deposits about once every 34 days. However, due to the improvement of the banking habit in Jordan this rate has increased steadily until it reached 20 times per year in 1982, but then started to decline. With the exception of the rate in 1985 which amounted to 20.35, the turnover rate has continued to decline over the past five years until it reached 16.75 times per year. This decline can generally be explained by the decline in the total value of demand deposits which has also led to a decline in total withdrawals.

Generally speaking, this low rate of demand deposits turnover indicates that

Table 6.7 : Turnover of demand deposits in Jordan, 1977-1987 (JD million).

Year	Cheques presented to clearing, (1)	Withdrawals other than clearing chqs.(2)*	Total withdrawals (3)=(1)+(2)	Total demand deposits, (4)	Turnover of demand deposits,(5)=(3)/(4)
1977	1199.12	599.56	1798.68	165.73	10.85
1978	1539.93	769.97	2309.90	172.50	13.39
1979	2201.57	1100.78	3302.35	213.14	15.49
1980	2797.74	1398.87	4196.61	288.10	14.56
1981	3837.77	1918.88	5756.65	316.51	18.18
1982	4725.70	2362.85	7088.55	354.50	20.00
1983	5067.09	2533.54	7600.63	387.76	19.60
1984	5117.75	2558.87	7676.62	409.64	18.74
1985	5134.04	2567.02	7701.06	374.6	20.55
1986	4344.20	2172.10	6516.30	370.64	17.58
1987	4233.96	2116.98	6350.94	379.1	16.75

* Calculated as 50 % of cheques presented to clearing.

Source : Central Bank of Jordan, *Monthly Statistical Bulletin*, Vol. 24, No. 1, 1988 (Author's calculations).

a substantial part of these deposits enjoys the stability that time and saving deposits enjoy which enhances the potentiality for commercial banks to offer long term finance.

However, from the previous review of the commercial banks' lending policy, it is clear that they are overly cautious. Like other enterprises in the private sector they seek to maximise profits in an idealized world of perfect certainty regardless of the economic and social development needs of the country. Accordingly, it can be said that the contribution of commercial banks to economic development of the country is insignificant. This was also conluded by many of those who discussed the subject; among them are Salah (1981) and Khatib (1987).

6.4 Specialized Credit Institutions (SCIs)

6.4.1 The Structure and Relative Importance

Jordan has six specialized credit institutions. These institutions are illustrated in Table 6.8 below:

Table 6.8 : The specialized credit institutions in Jordan

Credit institution	Establishment Year	No. of Branches
Agricultural Credit Corporation (ACC)	1959	12
Industrial Development Bank	1965	-
Housing Corporation	1965	-
Cities and Villages Development Bank	1966	-
Jordan Co-operative Organization	1968	10
Housing Bank	1974	81

Source : The Central Bank of Jordan, *Annual Reports.*

It has already been shown that commercial banks in Jordan are generally reluctant to extend sufficient credit to finance and promote the productive sectors because of the long term nature of the credit required and the high risk involved in providing it.

This situation led to the creation of the above credit institutions in order to finance the basic sectors of the economy, which had been given priority in the country's development plans.

All of the specialized credit institutions operate under special laws approved by the Council of Ministers. Legally, while the Agricultural Credit Corporation, the Housing Agency and the Cities and Villages Development Bank are considered as public entities owned by the Government, the other three institutions are regarded as semi-autonomous bodies jointly owned by both the private and the public sectors.

The relative importance of specialized credit institutions within the financial system of Jordan measured through their assets, deposits and credit is shown in Table 6.9.

The above table shows that these institutions constitute only a very small part of the financial system in Jordan. In 1987, their total assets only accounted for 16 per cent of total assets of the financial system in Jordan. If the share of the Housing Bank is excluded the ratio will decline to only 6.9 per cent.

This situation also applies to other indicators used in the table (deposits and credits).

6.4.2 Activities and Sources and Uses of Funds

Before examining the consolidated balance sheet of these institutions, a brief clarification of each will be provided as follows:

1) The Agricultural Credit Corporation (ACC):

This was the first specialized institution to be established in Jordan in 1959 with a capital of JD 7 million. It aims at extending credit to agriculture for various purposes. The duration of credit takes the form of seasonal and short-term credit; medium-term loans are extended mainly to buy machinery; and long-term loans to finance irrigation and land reform projects. The main source

Table 6.9 : The relative importance of specialized credit institutions within the Jordanian financial system (as at the end of 1987; JD million and percentage).

	Assets		Deposits		Credit	
Institution	JD	%	JD	%	JD	%
Banking system:	3829.0	74.3	2551.3	82.4	1753.1	73.8
- Central Bank	930.5	18.1	203.9	6.6	240.1	10.1
- Commercial banks	2898.5	56.2	2347.4	75.8	1513.0	63.7
Specialized credit instns.:	831.8	16.1	374.3	12.1	502.1	21.1
- Housing Bank	473.6	9.2	338.3	10.9	310.8	13.1
- Other sp. cred. instns.	358.2	6.9	36.0	1.2	179.2	8.0
Others	493.6	9.6	170.0	5.5	120.7	5.1
Total	5154.4	100	3095.6	100	2375.9	100

Source : Collected from the CBJ, *Monthly Statistical Bulletin*, Vol. **24**, No. 1, 1988.

of its funds is borrowing from foreign and domestic institutions including the CBJ, usually at a low interest rate between 3 to 5 per cent. In contrast, the interest rate it charges on loans range between 6 to 8.5 per cent. As is shown in Table 6.10, credit extended by the ACC to the agricultural sector increased from JD 10.6 million in 1977 to JD 30.4 million in 1987. However, when their contribution is compared to those of commercial banks, and the Jordan Co-operative Organization, it has declined from 47 per cent of total agricultural credit in 1977 to 37.0 per cent in 1987 (Calculated from the CBJ data). This decline could be related to the difficultiesin obtaining funds from both local and foreign sources.

2) The Jordan Co-operative Organization (JCO):

This organization was established in 1968 mainly to supervise, unify and vitalize the co-operative movement in Jordan, as well as to extend credit to the co-operative societies. It extends credit to co-operative societies for all terms and charges an interest rate of 6.5 to 8 per cent. The Jordan Co-operative Organization borrows from the CBJ at 3 per cent and from the Agricultural Credit Corporation at 5 per cent. The institution also accepts deposits and it has a role in providing credit and financing agricultural projects in Jordan.

3) The Industrial Development Bank (IDB):

The IDB was established in 1965 with a little less than half of its paid up capital held by the Government. It aims at extending industrial loans, including loans for tourism. Credit to the private industrial sector takes either the short or medium or long term. The bank charges on loans extended a flat interest rate of 7 per cent plus 1 per cent commission. Since 1983, the Bank started to accept deposits. The Industrial Development Bank is the leader in providing medium and long term loans to small businesses for working capital as well as investment. The Industrial Development Bank has also been involved in assisting the very small industries through the Small Scale Industries and Handicraft Fund (SSIHF). Advances extended by the IDB have increased from JD 10.8 million in 1977 to JD 40.3 million in 1987 (Table 6.10). The IDB also plays an important role in providing training for the private and public sector industries in accounting, finance, general management and marketing through the Jordan Management Institute.

4) The Cities and Villages Development Bank (CVDB):

This bank was established in 1979 replacing the Municipal and Village Loans Fund which was founded in 1966. It extends loans to municipalities and villages to implement development projects. Loans are granted to municipalities with interest rates of 7.5 to 8.5 per cent and to village councils with interest rates of 6 to 7 per cent. Although loans extended by the bank increased over the last decade the growth of its advances is still insignificant. The absence of long term plans on the part of the municipalities and the village councils which enable them to repay their loans is likely to be an important reason that makes the bank refrain from increasing its long term advances (The General Manager of the Bank in an interview with the *Banks in Jordan*, June 1988).

Table 6.10 : Credit facilities extended by the specialized credit institutions, 1977-1987 (JD million & percentage).

Year	HC		JCO		ACC		CVDB		IDB		HB		Total
	JD	%	JD	%	JD	%	JD	%	JD	%	JD	%	
1977	2.76	3.70	3.84	5.16	10.64	14.26	9.07	12.15	10.85	14.54	37.46	50.20	74.62
1978	2.52	2.64	4.85	5.08	11.61	12.16	11.04	11.56	13.40	14.04	52.05	54.52	95.47
1979	2.32	1.89	6.81	5.56	12.72	10.38	12.47	10.18	15.64	12.76	72.58	59.23	122.54
1980	5.05	3.30	9.30	6.07	14.05	9.18	13.41	8.76	18.14	11.85	93.14	60.84	153.09
1981	4.75	2.71	10.64	6.08	17.28	9.87	15.35	8.77	23.45	13.40	103.57	59.17	175.04
1982	6.00	2.70	18.84	8.48	20.22	9.10	23.36	10.51	30.83	13.87	123.02	55.35	222.27
1983	8.48	3.14	21.82	8.08	22.00	8.15	31.62	11.71	35.94	13.31	150.19	5.61	270.05
1984	9.65	3.09	21.96	7.04	22.48	7.20	36.07	11.56	37.81	12.11	184.11	59.00	312.08
1985	11.69	3.32	22.94	6.52	25.89	7.35	39.59	11.25	38.29	40.890	213.64	60.68	352.04
1986	20.14	5.36	11.29	3.00	28.05	7.46	45.26	12.04	39.26	10.44	231.88	61.69	375.88
1987	59.53	13.72	11.58	2.67	30.35	7.00	49.51	11.41	40.28	9.28	242.57	55.91	433.82

Source : The Central Bank of Jordan, *Monthly Statistical Bulletin*, Vol. 24, No. 3 - March 1988 (Author's calculation).

5) The Housing Corporation (HC):

The Housing Corporation was established in 1965 in order to help alleviate the housing problem in Jordan. This is through implementing housing projects such as al Hussein Housing Suburb, which was offered for sale to the public at payment terms of 15 years and at an interest rate of 5 per cent. The Corporation obtains its funds from various institutions inside and outside the country. In addition to the budgetary support, it borrows from the CBJ at an interest rate of 4.5 per cent. By 1977, the loans extended by the Housing Corporation amounted to JD 2.8 million but peaked at JD 59.5 million in 1987.

6) The Housing Bank (HB):

The Housing Bank was set up in 1974 under a special law excluding its operations from banking control regulations. The Bank was established to relieve Jordan from the acute housing crisis that emerged in the early 1970s as a result of the war with Israel, massive Palestinian immigration and a high national birth rate. Despite its nature as a specialized credit institution, the Bank is gradually becoming a fully fledged commercial bank. It has beome Jordan's largest lender with the widest branch network reaching 81 branches in 1987. The Bank in 1987 ranked second amongst the eighteen commercial banks in Jordan in terms of both its assets and deposit sizes when the latter amounted to JD 338.34 million and the former reached JD 473.57 million (The rank of the Bank in realtion to many indicators is shown in Chapter 8).

With such a financial basis, the Bank has become a leading force in credit facilities (See Table 6.10). From strictly retail bank operations dedicated to individual borrowers during the 1970s, the Housing Bank swiftly moved into wholesale banking since 1981. By that time, the Bank has increasingly started to deal with more private institutions such as the Real Estate Finance Co. (REFCO) or public institutions such as Government bodies or the Housing Corporation (The Housing Bank, *Financial Institution Report*, 1985).

However, the Bank's role in financing long-term housing projects is not unquestionable. An examination of the maturity structure of loans outstanding clearly indicates a declining trend in long-term credit offered by the Bank. While the latter accounted for 52 per cent of the total advances of the Bank in 1974, it declined to only 7 per cent in 1983 (The Housing Bank, *Annual Reports*, 1979, 1984). This clearly indicates that the Bank's policy is not in line with its main objective which is defined in its law as extending long-term credit to medium and low-income groups. Hence, the Bank is diverted from its assumed development responsibilities stemming from its nature as a specialized credit institution responsible for extending long-term credit to finance long-term housing projects.

In order to examine the sources and the uses of the SCI's funds Tables 6.11.a and 6.11.b have been prepared.

Table 6.11.a shows that the SCI's assets increased from JD 43.7 million to JD 831.8 million in 1987.

The Tables also show rapid growth in deposits as a major source of funds for the SCIs. While the share of deposits did not exceed 24.5 per cent of total funds in 1975 this ratio has more than doubled in 1980 when it amounted to 49.5 per cent. This rapid growth in deposits was due to the establishment of the Housing Bank in 1974 with its significant contribution to the assets and liabilities of the SCIs.

Total borrowing is another important source of finance for these institutions with a ratio of 27 per cent of total liabilities in 1987.

In their uses of funds, loans to the private sector and to municipalities and village councils are the main outlet. Their ratio to total fund has declined from 75.9 per cent in 1977 to 60.4 per cent in 1987. Liquid and negotiable assets come next with a ratio of 32.3 per cent as in 1987.

6.5 Other Banking Institutions

6.5.1 Financial Companies

The rise of the financial companies started in 1979 when the Arab Finance Corporation (Jordan) was established as the first of its type in Jordan. By the end of 1984 the numer of these companies reached seven.

Table 6.11.a : Assets and liabilities of specialized credit institutions in Jordan, 1975 & 1977-1987 (JD million).

	1975	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Liquid assets	8.7	10.7	24.4	29.8	47.5	80.9	55.4	56.5	50.7	70.7	92.0	124.1
Negotiable assets	2.5	8.5	11.9	16.9	16.0	33.0	53.9	90.6	111.8	127.6	147.4	145.0
Loans	30.4	80.1	104.6	131.4	163.0	196.5	255	317.9	375.1	416.5	441.3	502.1
Fixed assets	1.0	3.7	5.9	7.9	11.1	12.7	20.8	23.4	29.3	33.7	32.5	35.9
Other assets	1.1	2.5	2.9	4.3	9.8	10.8	20.4	20.2	24.2	19.0	24.9	24.7
Assets = liabilities	43.7	105.5	149.7	190.4	247.4	334.0	405.7	508.6	591.1	667.5	738.1	831.8
Capital & Res.	18.6	32.8	38.2	43.2	48.8	60.0	71.0	79.2	87.9	88.9	95.6	100.5
Deposits	10.7	36.7	61.7	86.2	122.6	170.0	178.9	234.3	270.8	291.5	325.3	374.3
Grants & aid	1.5	1.6	1.7	2.0	1.7	0.3	0.3	0.3	-	0.1	0.1	-
Borrowing from :												
Government	1.7	1.6	1.5	1.5	1.4	1.2	2.1	2.0	2.1	2.1	2.3	2.3
the CBJ	3.7	12.9	16.5	16.7	19.7	32.3	53.5	76.5	88.1	100.9	107.8	108.5
Foreign institutions	4.9	13.4	10.0	14.2	16.4	19.1	21.0	26.1	30.8	32.9	38.0	45.3
Other sources	0.7	1.2	12.4	13.2	19.9	26.2	39.2	54.7	63.3	66.9	69.5	69.4
Other liabilities	2.0	5.3	7.8	13.4	17.1	24.9	39.8	35.6	48.1	84.2	99.5	131.5

Source : CBJ, *Yearly Statistical Series, 1964-1983 sp. issue*, No. 20; CBJ, *Annual reports*, 1984-1987.

Table 6.11.b : **Assets and liabilities of specialized credit institutions in Jordan, 1975 & 1977-1987 (percentages).**

	1975	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Liquid assets	19.9	10.1	16.3	15.7	19.2	24.2	13.7	11.1	8.7	10.6	12.4	14.9
Negotiable assets	5.7	8.1	7.9	8.9	6.5	9.9	13.3	17.8	18.9	19.1	20.0	17.4
Loans	69.6	75.9	70.0	69.0	66.0	58.8	62.9	62.5	63.4	62.4	59.8	60.4
Fixed assets	2.3	3.5	3.9	4.1	4.4	3.8	5.1	4.6	4.9	5.1	4.4	4.3
Other assets	2.5	2.4	1.9	2.3	3.9	3.2	5.0	4.0	4.1	2.8	3.4	3.0
Assets = liabilities	100	100	100	100	100	100	100	100	100	100	100	100
Capital & Res.	42.5	31.1	25.5	22.7	19.7	17.9	17.5	15.6	14.9	13.3	12.9	12.1
Deposits	24.5	34.7	41.2	45.3	49.5	50.9	44.1	46.1	45.8	43.7	44.1	45.0
Grants & aid	3.4	1.5	1.1	1.1	0.7	0.1	0.1	0.1	-	0.02	0.01	-
Borrowing from :												
Government	3.9	1.6	1.0	0.8	0.6	0.3	0.5	0.4	0.4	0.3	0.3	0.3
the CBJ	8.4	8.4	11.0	8.8	8.0	9.7	13.2	15.0	14.9	15.1	14.6	13.0
Foreign institutions	11.2	12.7	6.7	7.4	6.6	5.7	5.2	5.1	5.2	4.9	5.2	5.5
Other sources	1.6	1.0	8.3	6.9	8.0	7.8	9.7	10.7	10.7	10.0	9.4	8.3
Other liabilities	4.5	5.0	5.2	7.0	6.9	7.4	9.8	7.0	8.1	12.6	13.5	15.8

Source : Calculated from Table 6.11.a.

Financial companies are privately owned and extend both short and long term finance . According to their Charter (see The CBJ :*The Financial and Banking System in Jordan*, 1986), however, they are excluded from extending overdraft facilities. Trade financing is conducted only when guaranteed by foreign specialized credit institutions or export guarantee institutions. In addition to lending they provide capital market services as stock brokers in the Amman Financial Market (AFM) or underwriters of new equity and bond issues, leasing and factoring services and assistance for merger, acquisitions and equity and debt restructuring. Unlike the commercial banks, financial institutions are not authorized to accept demand deposits. Their resources are mainly raised from time and savings deposits from the private sector.

Most financial corporations have also been active in raising funds for industry in the capital market and participating in Government-guaranteed syndicated loans. While total assets of these companies amounted to JD 260.46 million in 1987, their total deposits and the advances they extended that year amounted to JD 148.8 million and 120.64 million respectively (The CBJ : *MBS*, Vol.24, No.3, 1988).

For a period of time, two of the financial corporations, the Jordan Finance House and the Islamic Investment House, operated under Islamic principles. However, while the latter collapsed in 1986 (It will be examined in Chapter 9), the former has recently abandoned operating under the *Shariah* principles.

6.5.2 Real Estate Institutions

These are financial companies that operate in building (through contractors), selling and financing housing units in accordance with conditions stipulated or approved by the Central Bank of Jordan. By 1987, the number of these institutions, according to the Central Bank amounted to four*. Unlike the aforementioned financial institutions, the activities of the real estate companies are mainly confined to the housing sector through the provision of loans and of undertaking many of the other operations conducted by the financial companies (mentioned

* This is including: Real Estate Financing Corporation Ltd. (REFCO), Darko Investment and Housing Company, Beit al Mal Saving Investment for Housing Co. Ltd. and National Development and Finance Co.

earlier). The paid up capital of the real estate companies is a major source of their funds together with the deposits they receive from the public. The companies are authorized to accept both time and savings deposits. In 1984 their total deposits amounted to JD 10.1 million (The CBJ, *The Financial and Banking System in Jordan*, 1986).

6.6 Non-Bank Financial Institutions

6.6.1 The Postal Saving Fund

The Postal Saving Fund started its operations in September 1974 with the aim of mobilizing and attracting small savings. The Fund commenced its activities by opening eight branches in Amman and since then started to build up a broad network of branches all over the country. The number of its branches amounted to 290 in 1987. By the end of 1987, the Fund was able to attract 213,600 depositors whose deposits amounted to JD 7.7 million (The CBJ : *Annual Report*, 1987).

For the purpose of supporting the Fund's attractiveness the Fund provides a variety of incentives, innovates new savings schemes, such as savings for education and offers an interest rate of 7 per cent on its deposits, which is almost equal to that paid by commercial banks on their deposits.

6.6.2 The Pension Fund

The Fund was established in 1976 to make pension payments to civil servants and military personnel. This original mandate was, however, changed later and the Pension Fund was transformed to a public investment corporation. The capital of the Fund is entirely owned by the Government and in 1986 totalled JD 42 million plu JD 8 million reserves. Total assets of the Fund decreased by 6.5 per cent over the past five years when they declined from JD 59.42 million in 1983 to JD 55.53 in 1987. This is parallel with a decrease in investments in shares by 8.8 per cent due to difficulties caused by the Jordanian economy on investment holdiongs and new investment activity (Figures calculated from The CBJ, *Annual Report*, 1987).

6.6.3 The Social Security Corporation (SSC)

This corporation was established in 1978 to provide pension and disability payments to workers of the private sector. At the end of 1987, the total capital of SSC amounted to JD 233.9 million against JD 4.7 million in 1980. Loans extended by the SSC in 1987 amounted to JD 82.2 million against JD 64.6 million investments in bonds and shares (The CBJ,*Annual Report*, 1987). A considerable proportion of the SSC's investments is in equity participations in industrial concerns. Similarly to the Pension Fund, SSC investments have been mainly concentrated on large enterprises and, in particular, on Government sponsored projects.

6.6.4 The Representative Offices

These offices started their activities in Jordan in 1977 as representatives of foreign banks. Under the Central Bank regulations the Representative Office is to look after the interests of the foreign bank (which has no branches in Jordan) or foreign financial company in Jordan without the aim of making profits within the country. For this purpose, the office may report financial and commercial information to the parent organization that it represents, extend its advice to it on the investment opportunities available in Jordan and promote contact and dealings between it and local banks and financial companies. By the end of 1987, the number of representative offices working in Jordan amounted to 9.

6.6.5 The Money Exchange Companies (Money-changers)

Money exchange companies in Jordan operate under licence from the Central Bank issued commensurate with the law of currency exchange. A licence is only given to two groups of companies:

- public and private companies whose capital is not less than JD 50,000,
- public sector companies whose capital is not less than JD 25,000.

By the end of 1987, the number of currency exchange companies, according to the Central Bank data, amounted to 72 of which 34 are located in the capital, Amman. Under the current crisis of the Jordanian economy, the companies were, however, closed down in February 1989 by the Government who accused them of interrupting the financial market as will be explained later.

6.6.6 The Insurance Companies

In December 1984, the number of insurance companies in Jordan reached 34. On that date, they were instructed to raise their capital to JD 600,000 by the end of 1986 or to merge with other companies. Thus by the end of 1987, their number was found to be 26, of which 18 companies were Jordanian and the remaining 8 were branches of foreign insurance companies. In 1987, their assets totaled JD 63.9 million as against JD 28.8 million in 1980. The compensations paid out by insurance companies in 1987 amounted to JD 12.7 million against JD 28.7 million premiums collected by them (The CBJ, *Annual Report*, 1987).

6.6.7 Amman Financial Market (AFM)

The AFM was established by the Government in 1977 to mobilize domestic and foreign savings and direct them toward productive projects. Before the establishment of the Amman Financial Market, the sale and purchase of stocks used to take place through a few real estate agents and brokers without any listed prices. This made transactions costly and share prices contentious. According to its establishment law, the objectives of the AFM are to

- promote savings by encouraging investment in securities and direct such savings to serve the development of the economy;
- regulate and control issues of securities to ensure the soundness, care and speed of such dealings, to foster the financial interest of the country and to protect the small savers and
- gather and publish the information necessary to realize the above mentioned objectives.

Table 6.12 provides an overall picture of the AFM's activities from 1978 to 1987.

Table 6.12 : **Traded shares in Aman Financial Market.**

	Number of traded shares		Value of traded shares	
Year	JD mn.	Rate of growth%	JD mn.	Rate of growth%
1978	2.43	-	5.62	-
1979	6.53	168.7	15.84	181.8
1980	17.90	174.1	41.43	161.5
1981	29.23	63.3	75.42	82.1
1982	34.60	18.4	112.25	48.8
1983	36.32	5.0	119.61	6.6
1984	28.25	22.2	53.09	55.6
1985	31.25	10.6	64.32	21.2
1986	39.76	27.8	64.49	0.7
1987	85.76	115.7	142.56	121.0

Source : The CBJ, *Monthly Statistical Bulletin*, Vol. **24**, No. 1, 1988.

Data on shares include shares of service companies, manufacturing and mining enterprises, and financial and insurance institutions. Volume and value of traded shares in the AFM grew rapidly from 1978 to 1983. This was due to speculative pressures which dominated the stock market during the early 1980s and the active investment policies pursued by public corporation and financial institutions which in turn were driven by the demand of the economy for all sorts of goods and services. Since 1983, the activity of the AFM has registered a substantial and generalized decline paralleled by a drop in the price of shares. While the creation of the AFM represents major progress toward the establishment of an organized capital market and has offered new investment opportunities to Jordanian savers, it has basically failed to mobilize resources for small and medium private industrial development. The enterprises which have been financed through the sale of stocks on the AFM are mainly very large government sponsored concerns which should have been funded anyhow through other government backed sources. By law, the AFM is also entrusted with the responsibility for listing all bonds issued by the Government or by private companies. The sale of bonds by private companies is hampered by their limited attractiveness. To compete with tax free Government guaranteed bonds issued by the Treasury or by public corporations, these bonds would have to provide a return of 13 to 14 per cent. Limited attractiveness of private companies' securities is clearly related to high risks they carry under the slow down of the economy. Such risks were disclosed by Jaber (1989) in his analysis of the returns and the risks of investment in the Amman Financial Market. In short, they are closely tied to the unfavourable features of the Jordanian economy, mentioned earlier.

6.7 The Current Financial and Economic Crisis of the Jordanian Economy

A crucial conclusion of the Jordanian economy's review in the previous chapter is that Jordan's economy is excessively tied to forces outside its borders and largely beyond its control. However, the first indication that the system of living on borrowed time and money was stretched to its limit occurred in May 1988 when Jordan suffered a slump in the value of the Dinar prompted by the devaluation and a record decline in Central Bank foreign currency reserves. In fact, by mid-June, the banking and financial climate in Jordan had altered radically. The changes were brought about by Central Bank measures designed to cope with sudden new factors.

Following crisis days on 2 May and 2 June, when the Dinar dropped from \$1 = JD 0.355 to around \$1 = JD 0.390, the Central Bank stepped in to set a binding rate of \$1 = JD 0.355 - 0.360 for commercial banks and JD 0.370 - 0.375 for money changers (*MEED*, 19 August 1988).

At the same time the Bank floated interest rates on credit by maintaining the rate at 8 per cent, but removing the previous 1 per cent ceiling on commission. The 7 per cent ceiling on certificates of deposits of more than JD 1,000 and three months was removed. Banks were also directed not to grant credit against deposits in foreign currencies and told to end existing arrangements within three months (*al-Dustur*, 8 June 1988).

In further moves in late June, the Bank introduced new instructions and began to enforce previously ignored regulations designed to encourage the inflow of foreign currency and to discourage its flight. The regulations increased the amount local residents were allowed to hold in foreign currencies in Jordanian banks without restrictions to JD 50,000 compared to JD 30,000 previously and let Jordanians working abroad bring back any amount of foreign currency with no restrictions on its use. The rules maintained individual's rights to transfer JD 5,000 in foreign currency abroad annually for education, pilgrimage and health costs and set out the conditions whereby exporters may keep their export earnings in foreign currency. Regulations to restrict money-changers activities were also issued but lacked the strict enforcement. The ban on these included accepting deposits, issuing cheques and holding bank accounts outside Jordan (*al- Ra'i*, 27 June 1988). Although the regulations *maintain their right to maintain bank* accounts inside the country only, they continued to carry out transfers and issue cheques abroad and to maintain bank accounts outside the country (*MEED*, 19 August 1988). A further move designed to relieve pressure on the Dinar, was taken in on 22 September 1988 when the Central Bank floated interest rates on commercial banks and financial corporations deposits. The floatation of interest rates was expected to drive up local interest rates and attract more funds to the Jordanian Dinar. However, the Central Bank's moves to calm the exchange situation have largely been unsuccessful. Despite the upward trend of interest rates resulting from its liberalization, it was too late for such a move to convince the public to hold their savings in Dinar under the panic run on it. The man in the street was having doubts about whether his Dinar savings in the bank or under the mattress would maintain their worth under such circumstances and, thus, he opted to move into dollars.

The Dinar's big plunge came in mid-October, when the Central Bank announced the floatation of the Dinar. As a result, the Dinar started to decline steadily. By the 9 November 1988, the Central Bank rate was \$1 = JD 0.459 down from the \$1 = JD 0.422 set in mid-October. Free market rates were well adrift of these guideline prices with money- changers posting rates of \$1 = JD 0.560

on 9 November down from \$1 = JD 0.522 two days earlier. Commercial banks were trading at about \$1 = JD 0.500. The floating of the Dinar was followed by a series of other measures announced by the Government on 5 November.

The Government froze wages in belief that Jordanian business should not lose the competitive advantage given to it by the devaluation. It raised tariffs on non-essential imports and banned the import of luxury items, including cars, caviar, chandeliers (on which it expects to save about \$ 3 million), marble and microwave ovens, until the end of 1989. Officials also voiced concern that the Government was increasing its efforts to cut its own spending, initially by reducing its ministeries' spending on minor items and by not embarking on new infrastructure projects. In the long run, its aim is to reduce the number of its employees who at present make up a third of the labour force in Jordan (*Financial Times*, 20 December 1988).

However, all the above measures failed to stem the sharp and continuing decline in the Dinar. This has precipitated drastic action against local money-changers charged with causing the Dinar's decline. The Government invoked martial law on 8 February 1989 to close all offices of money-changers. More than 70 exchange houses were sealed by the police without warning, their licences cancelled, their accounts at banks and other financial institutions frozen and their books seized for inspection. The move came when money-changers were trading at rates up to \$1 = JD 0.660 instead of the official \$1 = JD 0.570 (*MEED*, 17 February 1989). Besides moving against the money-changers, the Government, on 9 February, ended the practice of floating exchange within the so-called managed daily bands and replaced it with a strictly prescribed exchange rate. The price of the dollar was set at JD 0.540. However, it was clear that such a late move lacked credibility since the Government failed to strictly enforce the suggested exchange rate which represents a devaluation of the Dinar against the dollar of over 48 per cent (over 73 per cent at the free market price) since June 1988 (EIU *Country Report*, No. 2, 1989).

This unprecedented financial and economic crisis of the country was manifested in serious economic and financial indicators. On 1 February 1989, Jordan formally pulled out of a new loan in the international market. The proposed loan was to have been for \$ 150-160 million. It was to have been underwritten by the Arab Bank, the Arab Banking Corporation and the Gulf International Bank. Most observers agree that this was not because such a loan was not required - the urgent need for it was manifest - but because if it had been placed in the market it would have failed (EIU *Country Report*, No. 2, 1989). This represents a remarkable challenge to the Jordanian economy as being uncreditworthy. Another important indicator was reported by the *Financial Times* on 2 February, 1989 that:

> " the Jordanian Government for the first time delayed repaying an instalment on a syndicated commercial bank loan".

The reported default related to a principal payment of \$ 16.5 million due to the Arab Bank on a \$ 150 million syndicated loan agreed in July 1984. It was subsequently revealed that the Central Bank of Jordan had stopped payments on bilateral loans since the start of 1989. This made it inevitable that Jordan would have to seek rescheduling of its debt through the Paris Club of Western Creditor States.

A the end of March 1989, *Jordan called in the IMF seeking emergency balance* of payments' assistance and sponsoring rescheduling of its debt. Consequently, an agreement between the Jordanian Government and the IMF was announced in April 1989. It involved a \$ 125 million stand-by credit from the IMF and a \$ 100-150 million loan from the World Bank to be distributed over a period of 18 months to two years, to facilitate the rescheduling process. The decision finally to go to the IMF was taken after much debate in the country. The withdrawal from the Eurodollar loan appears to have convinced sceptics that Jordan's financial reputation had already been undermined and that the IMF's assistance would not damage it further (EIU *Country Report*, No. 2, 1989). Jordan saw the IMF's readjusted package as the only option available to salvage some of its international economic credibility.

According to this programme, the budget deficit will be narrowed, although the aim of reducing it from 24 per cent of GDP to 10 per cent in two years is very ambitious. The trade deficit is also set to contract further. However, such ambitious goals are largely dependent on other less certain targets; the extent to which Government spending will be kept under control which will largely determine economic growth; future levels of Arab aid, which may fall short of current expectations; and the level of remittances which is largely dependent on the value of the Dinar. There are also the political implications of a declining standard of living and the growing unemployment rate which may cause the Government and the IMF to review their austerity measures. In line with this, the Fund was embarassed by the unrest which erupted in April 1989, shortly after the announcement of the readjustment programme, and since then made a major concession by accepting that the Government will spend some $100 million on subsidies of stable goods in 1989. Jordan's stability was seriously undermined by a wave of unrest and violence which was described as the worst Jordan has witnessed since the Civil War ended in 1971* (EIU *Country Report*, No. 3, 1989). The unrest was sparked off by the Rifai Government's decision to increase prices on a range of goods by up to 50 per cent. However, it is agreed by observers that the outbreak of unrest was not a mere reaction to such a decision. The crisis brought feelings of resentment and bitterness to the fore, with the Jordanians being both angry and frustrated at the prospect of at least a decade of a much lower standard of living than they have enjoyed recently (EIU *Country Report*, No. 3, 1989).

Thus, soon after his return from the United States, King Hussain accepted the resignation of the Rifai Government and a new cabinet was formed†. Soon after this change in Government, both the Governor (Hussain al-Qasem) and the Deputy Governor (Maher Shukri) of the Central Bank of Jordan resigned, and Mr. Muhammad Sa'id Nabulsi, the former Governor of the Bank, returned as its head. Now that the developments of the crisis have been clarified, the roots and the main causes of it should be briefly identified as follows:

- Principally, the chief reason behind Jordan's current economic and financial crisis is the chronic structural weaknesses of its economy which has been manifested in many uncomfortable facts shown in the previous chapter. However, the crisis has developed since the beginning of 1987, when many unfavourable

* It is reported that at least eight people are known to have died and over 50 were injured during the clashes.

† Jordan's new prime minister is Sharif Zaid bin Shaker, a distant cousin of the King and, until December 1988, the Commander-in-Chief of the Armed Forces.

indicators appeared in the economy as mentioned earlier and as will be further stressed here.

- The effect of the downturn in the domestic economy, caused by a drop in Jordanian trade with the Gulf states, as well as the fall in remittances from Jordanians working there. By the beginning of the crisis, remittances had fallen to two thirds of their 1986 levels. (*The Financial Times*, 20 December 1988)

- The sharp decline in the Central Bank's foreign currency reserves. In April 1988, the start of the crisis, reserves were estimated at only \$ 28 million (*MEED*, 19 August 1988). It is said that it is a scandal that the \$ 1 billion of official cash reserves that Jordan had a few years ago should have been allowed to dwindle virtually to nothing. Senior officials, who knew the Government's intentions of taking new measures, are accused of having moved money out of the country just before the devaluation was announced (*The Financial Times*, 20 December 1989).

- The heavy burden of Jordan's total external debt was much higher than had been previously assumed. According to the Governor of the Central bank, Mr al-Nabellsi, the figure of external debt was by mid-1989 \$ 8.1 billion (al-Nabellsi, 1989). Some bankers have estimated this as being the equivalent of 225 per cent of Jordan's GDP (EIU *Country Report*, No. 3, 1989).

- The debacle over Iraqi exports. In fact, the growth of external debt has been partially offset by the accumulation of a \$ 600 million loan to the Iraqi Government. This stemmed from the Jordanian Government having paid its own businessmen for goods they imported and shipped to Iraq, having accepted promissory notes from the Iraqi authorities. The loan was much bigger than the country's liquid foreign exchange reserves. As the reserved dwindled to nominal levels, the Central Bank in its statistics amalgamated them with the loan to make the country's official foreign exchange position seem better (*The Financial Times*, 20 December 1988).

- King Hussain's announcement on 31 July 1988 to sever all legal administrative relations with the West Bank. This decision, as well as other changes which followed it on the political front, was soon reflected in the economy where Palestinians held key positions in the Jordanian private sector. There was a particularly steep drop in remittances from Jordanians abroad. Palestinians from the West Bank working in the Gulf States were worried about having their Jordanian passports withdrawn. As they started to think of retiring to countries other than Jordan, they kept their investments in the big international capital markets. At the same time, by some estimates, West Bank Palestinians withdrew some JD 50 million from Jordanian banks in the wake of the move, bought dollars or other foreign currency and shipped the money abroad (Rosenberg, 1988). However, in the end, it was the Palestinians of the West Bank and the Gaza Strip who lost the most. In one of its measures taken to crush the *Intifada*, Israel restricted the flow of funds into the Occupied Territories, imposing a 400 Dinar ceiling on the amount of money that could be brought from Jordan on any one trip. That meant, millions of West Bank and Gaza Strip Dinars stood in Amman banks losing more than 40 per cent of their value over the panic, while their unfortunate owners watched it all happen on the other side of the river.

- Jordan's climate also contributed. The coldest winter in 20 years aggravated the situation; agriculture has suffered with exports falling by 90 per cent (*Crescent International*, 16-31 March 1989).

- The sorry state of the Jordanian economy under the current crisis is attributed to the imbalanced and ineffective policies taken by the Government to tackle the crisis. The new measures of the Dinar floatation and the restriction on some imports had the opposite effect to that desired and the crisis deepened. The value of the Dinar kept declining amid rumours of money being smuggled out of the country by businessmen. Even the Central Bank which is responsible for guarding and guaranteeing the stability of the financial market, was shaken by the enormity of the crisis, it entered the market to buy dollars in a vain attempt to rebuild its depleted reserves of foreign currencies.

On the whole, Jordan faces some lean years now, which have already been accompanied by the inevitable inflation which followed the currency devaluation as the cost of imports rose. From -0.3 per cent in 1987, inflation, according to some forecasts, will exceed 14 per cent by the end of 1989 (EIU *Country Report*, No. 3, 1989). More seriously, then austerity is likely to be felt most severely by a group of people the Government least wants to suffer - the educated middle class who will be affected by higher unemployment.

Chapter VII

Origins and Development of the Jordan Islamic Bank

7.1 Introduction

The experience of Islamic banking in Jordan is of particular interest as Jordan has often faced severe economic difficulties and at the same time has witnessed the first collapse of a present day Islamic financial institution (The Islamic Investment House). However, the position of the Jordan Islamic Bank is the central concern of the empirical study of this thesis. Measured by asset size, the Jordan Islamic Bank was classified as the third largest Islamic bank in the world in 1987 (*The Banker*, December 1988). The present chapter is a review of several issues in its experience covering almost all its activities. This chapter is divided into eight sections, including this introduction. Sections 2 to 5 cover various important issues including the establishment and the objectives of the Bank, its management and the environment in which it operates. Consideration is also given to the Bank's branch network and its relations with the Central Bank of Jordan, as well as other banks and financial institutions. While the sources of the Bank's funds are demonstrated in Section 6, a comprehensive review of the uses of its funds is provided in Section 7. Sources of the Bank's income, as well as the matter of its liquidity versus that of commercial banks, are examined in Section 8. Overall, this chapter provides a background against which the performance of the Bank can be assessed. This will be the focus of the next chapter.

7.2 Preliminary Background

7.2.1 The Establishment of the Bank

Influenced by the contemporary Islamic revival, the monetary authority of Jordan responded positively to the initial suggestion made concerning Islamic banking and acted in an accommodating way to the introduction of this type of banking into the country. Accordingly, the Jordan Islamic Bank for Finance and

Investment* was established by a temporary special law, Number 13 of 1978, published in Official Gazette No. 2773 of April 1st 1978.

According to its former general manager, Dr. Sami Homoud, the Bank was the first amongst all Islamic banks in the world to be established under special legislation which facilitates its operation in an interest-based economy (Interview with him, conducted by the author in Amman, January 1988). With its headquarters in Amman, the Bank was registered as a public shareholding limited company in the Commercial Registers, under law No. 124, in accordance with the requirements of the Jordanian Company Law. The authorised share capital of the Bank was JD 4 million and the initial paid up capital was JD 1 million. In 1985, the law establishing the Bank was confirmed as a permanent law when the Bank's Law No. 62 was passed. Some amendments were made to the Articles of Association of the Bank during the period 1981-1986. The major change provided for an increase in the Bank's authorised capital to JD 6 million, a decision which was ratified by the General Assembly of the Bank at a meeting on 21st December 1985.

7.2.2 The Objectives and Functions of the Bank

As an Islamic institution, the Articles of Association of the Bank has emphasised that the Bank should avoid *riba* in its dealings and activities and affirmed that this is an obligation under all conditions and operations. Hence, any regulations, rules or instructions which the Bank may issue in violation of this obligation have no legal effect.

The law also stipulates that the Bank aims at meeting the economic and social needs in the field of banking services, financing and investment operations on a *riba*†-free (interest-free) basis with particular reference to the following goals:

- Expanding the extent of dealings within the banking sector by offering interest -free banking services with special emphasis on introducing services designed

* For the sake of abbreviation, the Bank is referred to in this study as the Jordan Islamic Bank

† The Jordan Islamic Bank Law is one of the few examples of legislation on Islamic banks which has attempted to define the term *riba*.

to revive several forms of collective social responsibility on a basis of mutual benefit.

- Developing instruments to attract funds and savings, and allocating them to interest-free banking investment.

- Providing the necessary financing to meet the requirements of the various sectors, particularly those which are not likely to benefit from *riba*-banking facilities.

In order to realize the above objectives, the Bank is allowed to carry out operations in the following fields:-

1) Interest-free banking operations:-

The Bank practices, whether for its own account or for the account of others, within or outside the country, all traditional or new banking activities as it is able to undertake within the defined limits, including the following:

- Accepting cash deposits and opening of current and deposit accounts of various types, payment and clearance of cheques, collection of bills of exchange, transfer of funds within or outside the country, opening of documentary credits and notification thereof, issue of bank guarantees, personal letters of credit and credit cards and other banking services.

- Dealing in the exchange of foreign currencies on the basis of spot rates only.

- Giving fixed term loans as a mere service, without interest (*Qard Hasan*) either by discounting commercial short-term promissory notes or by instalment lending.

- Management of properties and other assets which can be managed by the Bank on the basis of an agency fee.

- Acting as chosen trustee to manage the legacies and execution of bequests in accordance with Islamic *Shariah* and the laws in force in cooperation with the *Shariah* authority of the bank.

- Carrying out of special studies on behalf of the clients of the Bank and giving information and consultancy services on various matters.

2) Social services:-

The Bank acts as a trustee in organizing social services designed to strengthen the ties of solidarity and co-operation among various groups and individuals. It achieves this through providing loans for productive and social purposes, setting up and managing special funds allocated for these objects, and any other activities within the scope of these general objectives.

3) Financing and Investment Activities:-

The Bank can carry out interest-free financing and investment operations by the following means:

- Providing the necessary finance, fully or partially, in the various cases and undertakings which have a potential to be self-supporting. This includes decreasing participation, *Murabaha* and other permissible forms of financing.

- Investment of funds, the owners of which desire to invest them jointly with other resources available to the Bank on a joint *Mudaraba* basis. In particular cases, the Bank may employ the funds in a specified manner by special agreement.

- The Bank may directly invest funds in various projects, provided that the total permanent investments of the Bank must not exceed 75 per cent of the total paid up capital and compulsory reserve.

- Establishment of companies in various fields to take possession of moveable and immoveable properties, to exploit, rent and develop them in various activities - agricultural, industrial, housing and others.

7.3 The Management of the Bank

The main bodies which manage and supervise the Jordan Islamic Bank are the Board of Directors and the General Assembly. This is in addition to the

"*Shariah* Supervision Authority", which, in the case of the Jordan Islamic Bank, is restricted to a single advisor rather than a board.

7.3.1 Board of Directors

The Bank is managed in the same manner as shareholding companies by a Board of Directors elected by the shareholders with a four year term of service. When the Bank started its operations in September 1979, the Board of Directors had eleven members, but later this number was reduced to seven. A decision for this amendment was taken by the General Assembly of the Bank at a meeting on 5th May 1981. To qualify for membership of the Board of Directors, the member should be a holder of at least 5,000 shares, although no explanation was provided for this regulation.

Furthermore, it is stipulated, perhaps surprisingly, that if a member of the Board of Directors' shareholding drops below 5,000 shares during the term of membership, he or she would automatically be dropped from the Board. Although, the Bank's regulations provide that the Board of Directors be managed by a chairman, nothing relating to the manner in which the chairman is appointed is mentioned. The Board may appoint a General Manager from amongst its members or from outside. The General Manager is given the authority to be responsible for the management of the Bank. The Board of Directors convenes whenever this is deemed necessary by the Bank's interests, provided that it meets no less than six times a year. More than half of the members of the Board should be present at the meeting so that its decisions can be considered legal. The decisions of the Board are taken by the absolute majority of the members present. In the case of a tie-vote, the chairman is given a casting vote. In some exceptional cases, however, decisions require the approval of two-thirds of the members. The selection or the appointment of the General Manager is an example of this. In order to operate effectively, the Board of Directors enjoys such powers as will enable it to carry out its work with the necessary flexibility. Since the early 1980s, some changes took place in the membership of the Board of Directors. The major change was the appointment of Sheikh Saleh of Saudi Arabia as Chairman of the Board of Directors in late March 1980, though his holding in the Bank was below JD 250,000. The al- Baraka Investment and

Development Company has a similar shareholding. This company which is Jordanian, and wholly owned by al- Baraka International, has been represented on the Board of Directors since 1983. Another major change was the departure of Dr. Sami Homoud, the Vice-Chairman of the first Board and the first General Manager of the Bank. Dr. Homoud has made a useful contribution to the literature of Islamic banking, mainly in his suggestion of the *Murabaha* arrangement as mentioned earlier. In an interview with him in Amman in January 1988, he refrained from giving the reasons behind his resignation from the Bank. Currently, Mr. Musa Shihadeh, who is an economics and accounting graduate with long financial experience, occupies the post of General Manager of the Bank. He joined the Bank in June 1980.

7.3.2 The General Assembly

The General Assembly consists of all shareholders regardless of the numbers of shares they own. Each share has one ordinary vote whether the shareholder attends the meeting in person or through a representative. Three types of General Assembly meetings were defined by the Bank's regulations. The first is the Constituent Assembly Meeting. This elects the first Board of Directors, designates the external auditors and declares that the Bank has come into existence. The second is the Ordinary General Assembly. The authority of this assembly is the same as that elsewhere. It includes making decisions on every matter that is in the Bank's interests. The selection of members of the Board of Directors and the approval of the balance sheet and financial results are examples. The third type of meeting is the Extraordinary General Assembly. This convenes upon a direct invitation of the Chairman of the Board of Directors or upon a written request of shareholders owning no less than 25 per cent of the Bank's shares.

In general, a meeting of any of these types is not regarded as legal unless it has a quorum of shareholders representing more than half of the Bank's shares. Contrary to this is the case of the dissolution of the Bank. Representation in such a meeting of the Extraordinary General Assembly held for this purpose must be no less than two-thirds of the Bank's shares. Decisions are also taken by the ordinary majority of shareholders represented in the meeting. This applies except in the following decisions that require the approval of 75 per cent of the total number of shareholders represented in a meeting of (usually) the Extraordinary General Assembly:

- Amending the Bank statute or its law.
- Merging the Bank with another institution.
- Dissolution and liquidation of the Bank.
- Dismissing a member of the Board of Directors.
- Transfering the Bank's head office outside Jordan, provided that this measure is approved by the competent Minister.

7.3.3 The *Shariah* Control Authority

The task of the *Shariah* control authority within Islamic banks is simply defined as to ensure that the banks' dealings and activities are compatible with the principles of the *Shariah.* Unlike those of many Islamic banks, this task within the Jordan Islamic Bank is restricted to a *Shariah* advisor rather than a board or committee.

According to the Bank's law, the Board of Directors is entitled to appoint and dismiss the *Shariah* advisor. His remuneration also is to be fixed by the Board of Directors. Thus, it can be argued that such a status for the *Shariah* advisor may threaten his independence to give the correct judgement without undermining his own position. Therefore many Islamic banks, including all the Faisal Islamic Banks, have established a *Shariah* Control Committee. In addition some Islamic banks, to ensure an effective control process, have constituted their *Shariah* control committees from both economists and *Shariah* scholars (*Ulama*). Moreover, in other Islamic banks the *Shariah* control committee has the right to be represented in most of the banks' divisions and departments which are entitled to ratify the banks' operations. This will certainly enable the *Shariah* Control Authority to carry out its inspection and auditing more precisely and clearly verify whether the banks' operations are in conformity with the *Shariah* or not.

It is worth mentioning here that the experiment of the Tadamon Islamic Bank of the Sudan is an important example in this regard. As far as the experiment of the Jordan Islamic Bank is concerned, the *Shariah* advisor prepares an auditing report which is regarded as part of the annual report. Since the establishment of the Bank, and like any other Islamic bank, the subsequent reports of the *Shariah* advisor have always emphasised the conformity of the Bank's operations with the *Shariah* principles. However, it is a long established opinion that it would be more credible if these reports were made by a committee (including both Muslim jurists and economists), rather than an advisor as will be further emphasised in the next chapter. This is particularly recommended in the case of the Jordan Islamic Bank as its *Shariah* advisor, Sheikh Abdul Hamid El Sayieh, only works part-time with the Bank. He is better known internationally as the Chairman of the Palestinian National Council.

7.4 The Environment in Which the Bank Operates

One of the basic necessities for successful economic activity is the existence of a healthy environment. In the case of the Jordan Islamic Bank, the environment in which the Bank operates can be seen as a combination of four basic elements. Each of these elements can be briefly highlighted as follows:

7.4.1 The Economic Climate

As was shown in the previous two chapters, the Jordanian economy is suffering from a severe recession. Historically, it has been characterized by some unfavourable features, such as a high degree of dependancy on the external world, a chronic balance of trade deficit and the absence of comprehensive development planning. In addition, from the ideological point of view, a western-oriented framework for development is in contradiction with the basic requirements for conducting Islamic finance. The financial institutions and instruments in Jordan are large, well developed and diversified. In a narrow and overcompetitive financial market, the Jordan Islamic Bank is surrounded by 17 commercial banks, 6 specialized credit institutions, 11 financial companies and several non-bank financial institutions. Competition between these institutions has made it difficult for any of them to achieve any remarkable success. These must be either in accepting deposits or in conducting other banking and investment activities.

In a rather disorderly market, the problem from the perspective of the Jordan Islamic Bank is naturally accentuated.

In the well tried and tested interest-based banking environment, it is not an easy task for the bank to compete with the conventional banks and financial institutions, which are very well established, while it operates on an interest free basis. In comparison with conventional banks, it can offer no guaranteed return to its depositors and involves them in higher levels of risk. In addition, the *riba*-oriented mentality of most clients proves a barrier to their understanding of the modes of finance offered by the bank.

This, combined with the many legal restrictions imposed by the monetary authorities, will have a negative impact on the performance of the bank.

7.4.2 The Political Climate

It is well known that the investment climate in most of the Middle Eastern countries is characterized by a variety of uncertainties. They spring from the political instability which directly affects Jordan. In one way or another, the latter has been involved in the so-called Arab-Israeli conflict. King Hussain's dramatic step taken in late July 1988 (as mentioned earlier), is only one example of this instability, when he decided to sever Jordan's administrative and legal links with the Israeli-occupied West Bank. Such a step has resulted in considerable confusion among Palestinians in the West Bank and East Bank (where the Palestinians constitute 60 per cent of the total population) alike.

More relevantly, the degree to which the Jordanian economy is affected by the political climate of the region can be judged from the relationship between Jordan and other Arab countries which have experienced serious economic and political difficulties.

The booming performance of the Jordanian economy during the 1970s was entirely geared to the oil boom in the neighbouring oil-exporting Arab countries. It was on a considerable scale (as shown earlier), financed by capital inflows from Jordanians working in these countries. The collapse of the oil boom, which is closely tied to politics and the growing financial tensions in the oil-exporting economies, has proved adequate reason for the recession in Jordan's economy. Together with the Gulf War, which has hurt the Iraqi economy (a major export market for Jordan), they have been the major factors for this recession since 1982.

In short, uncertainties prevailing in the region have left a negative impact on the investment climate and hence affected the banking system, including the Jordan Islamic Bank. On the other hand, and like most Islamic banks elsewhere, the Jordan Islamic Bank has faced attacks from different parties motivated by both political and ideological affiliations. Doubts and misgivings about the viability of business conducted on a non-interest basis are expressed by secularists in both the public and private sectors, although public media can say nothing openly against the bank.

7.4.3 The Legal Climate

Although the bank was set up under special laws which exempt it from the *riba*-based rules, it is subject to many regulations and measures that govern traditional banks in spite of the fact that the Bank works differently. Regulations of the Civil Law, the Commercial Law and the Banking Act hinder the freedom of the Bank. If the Fees Law is taken as an example, it stipulates that in the land-registration regulations, the client has to pay repeated fees, amounting to 16 per cent of the financing cost in the case of financing real estate. This is a burden on the clients which may lead them to refrain from dealing with the Bank. At the same time, the Bank cannot invest in some instances because of rules and measures governing its operations. This will be further explained when discussing the relationship between the Bank and the Central Bank of Jordan.

7.4.4 The Moral and Social Climate

It is commonly asserted that the success of Islamic business is highly dependant on the extent to which the behaviour of individuals within the society corresponds to the *Shariah.* Straightness, fairness, honesty and integrity of both the Bank's staff and the clients are indispensable conditions for this success. Unfortunately for Jordan, Islam, as shown earlier, is not given its rightful place as a comprehensive way of life. While its practice is widely restricted to merely ritual forms, the behaviour of most individuals within the society no longer represents the real image of Islamic behaviour. It is a genuine fruit of the entire set of laws, statutes, rules and customs with all its un-Islamic political, social, economic, educational, cultural and ideological implications. Thus, the environment in which the Bank operates is characterized by the absence of basic requirements, including the adherence to Islamic values and ethics in business, along with the lack of public awareness of Islamic banking and its advantages. The above picture constitutes a real dilemma for the Bank. In other words, from the very first minute of its operation, the Bank had to face the challenge that the public hardly knows anything about how to deal according to the *Shariah.*

On the whole, to judge the performance and the results achieved by the Jordan Islamic Bank, the aforementioned environmental circumstances must be taken into consideration. It is clear to see that in an un-Islamically constituted environment, such as that of Jordan, the main concern of any existing Islamic bank will be to adopt the more convenient approach and the appropriate policies to the situation at hand within the limits of the *Shariah.*

7.5 The Bank's Expansion

7.5.1 The Bank's Branch Network

In spite of the unfavourable background shown above, the Jordan Islamic Bank managed to expand its business to various areas of the country within a short period. The first branch of the Bank commenced its operations in September 1979 in the capital city of Amman. The Bank started to open new branches from its first year of operation. At the end of 1988, the total number of the Bank's branches reached 15 (including the headquarters) in addition to another branch under establishment. The choice of location for a branch of the Bank is largely dependent on the potential number of customers, as well as the economic activity in the area. Compared with commercial banks operating in Jordan, the success that the Jordan Islamic Bank has achieved in this regard is somewhat significant, although the concluding assessment of this achievement will be carried out in the next chapter.

7.5.2 The Bank's Relations with the Central Bank

The Bank practices the various banking operations according to the same Acts followed by the licensed conventional banks in the country. This is except for what is incompatible with the Bank's obligations as prescribed in its special law, that it is to be operated on an interest-free basis. Thus, the Bank is confined to the Central Bank's regulations, including the prescribed reserve requirements, liquidity ratios and other constructions related to credit control in the country. The Bank is also deprived of the different facilities given to the other banks. In line with this, the Bank does not benefit from facilities rendered by the Central Bank as the lender of the last resort for those banks in cases where there is a need for prompt liquidity. Unlike the commercial banks, the Bank is also excluded from facilities given to the banks to encourage exports at a reduced discount rate. This is another factor to be added to those which make the cost of financing through the Bank, higher than that of other banks.

In such circumstances, the Bank has found itself forced to adopt some policies which may be criticized by many, as will be explained later.

7.5.3 The Bank's Relations with Other Banks and Financial Institutions

Since its establishment, the Bank has been able to set the basis of dealings with other banks and financial institutions pursuant to its law and its interest-free transactions. The first priority is undoubtedly given to Islamic banks if they are found, otherwise the Bank will be obliged to refer to other banks which understand the principles of the Bank's operations and agree to deal with it accordingly. In line with this, cooperation between the Bank and other Islamic banks and financial institutions in funding some projects has been stressed. The huge financing of an Alia airplane purchase, which amounted to JD 50 million, is only one example. The project was carried out jointly with the Kuwait Finance House, the Islamic Investment House and al-Baraka Investment and Development Company. The contribution of the Jordan Islamic Bank in this project amounted to JD 10 million (provided by the Bank's management).

On the other hand, the Bank has also succeeded in setting up good connections with foreign banks in line with the same basis stated above. It has established a correspondent network abroad. Its dealings with these banks are indicated by the value of the credit letters on its balance sheet; at the end of 1987, the total number of credit letters amounted to JD 5.16 million, although this outstanding balance does not reflect the entire value of dealings that took place over the year in this respect.

It is worth mentioning here that the main purpose of such dealings is to cover the value of the Bank's imports with foreign currency.

Another issue that requires attention is the Bank's relationship with the International Association for Islamic Banks (IAIB). Like many other Islamic banks, the Jordan Islamic Bank is not a member of the IAIB. The Bank's management, however, provides no clear explanation for the matter. They only argue that nothing could be added to the effectiveness of the Bank by becoming a member of IAIB. This gives the impression that there are some differences of opinion between the two entities on different issues related to the application of Islamic banking. Such a view has been supported by the former General Manager of the Bank, Dr. Sami Homoud, when interviewed by the author as mentioned earlier, although he gave no details about the matter.

7.6 The Sources of the Bank's Funds

The Bank's financial resources are composed of:

- Self-raised sources including the paid up capital, reserves and the retained profits; all of which constitute shareholders' equity.
- Deposits which constitute the major source of the Bank's funds, in addition to other resources that are less important.

7.6.1 Shareholders' Equity

This includes the paid up capital, reserves and the retained profits. Each of these can be highlighted as follows:-

1) Capital:-

It has already been stated that when the Bank started its operations in September 1979, the authorized capital was JD 4 million divided into 4 million shares. The nominal value of each share is one JD. In 1986, however, the authorized capital was increased to JD 6 million, as mentioned earlier. This increase has been implemented firstly to meet the regulations of the Central Bank of Jordan which require the minimum capital of any bank to be JD 5 million and, secondly, in response to the growth and development of the Bank. Table 7.1.a shows the development of the paid up capital of the Bank. While the initial capital represented only 25 per cent of the authorized capital, the ratio of the paid up capital to the former reached about 75 per cent when it amounted to about JD 3 million at the end of 1981. By the end of 1982, the authorized capital was fully paid up. In 1986, the paid up capital increased to JD 6 million to fulfil the management's decision mentioned earlier.

As such an increase was immediately carried out the authorized capital was fully paid up. However, this is not usually the case with other Islamic banks where there is often a wide gap between the paid up capital and the authorized capital. One such example is the Faisal Islamic Bank of Egypt (FIBE). While its authorized capital was set at US$ 500 million the issued capital was US$ 100 million and until 1987 the paid up capital was only US$ 70 million; that is to say, the paid up capital represents only 14 per cent of the authorized capital (FIBE, *Annual Report*, 1987).

2) Reserves and retained profits:-

The Jordan Islamic Bank maintains three types of reserves. The first is the legal (the statutory) reserve which is added to annually by 10 per cent of the net profits. This reserve accumulates until its balance equals the paid up capital. The second is the voulntary reserve which is determined by the Bank's management; the annual amount transfered to this reserve fund must not exceed 20 per cent of the net profits. The third final reserve fund is the special reserve which is allocated to meet any commitments or losses incurred by the special investments of the Bank. Like the voluntary reserve fund, the annual deduction from net profits to this fund should not exceed 20 per cent. Although the Bank started building up its legal reserve at the commencement of its operations in 1979, the

Table 7.1.a : The development of the paid up capital and the reserves of the Jordan Islamic Bank, 1980-1987 (JD 000).

Year	Paid-up Capital*(1)	Its ratio to the capital % (2)	Total reserves & retained profits (3)	Share-holders' equity (4)=(1)+(3)	Total reserves to shar. eq. (5)=(3)/(4)	Total res. to assets (6)
1980	2000	50	6	2006	0.30	0.04
1981	3000	75	82	3082	2.66	0.26
1982	4000	100	265	4265	6.21	0.59
1983	4000	100	398	4398	9.05	0.56
1984	4000	100	793	4792	16.55	0.78
1985	4000	100	1068	5068	21.07	0.84
1986	6000	100	3988	9988**	39.93	2.47
1987	6000	100	4115	10115	40.68	2.08
1988	6000	100	4376	10376	42.17	1.96

* The initial capital was one million JD.

** This includes an increase of capital with JD 2 million and the legal reserve on this increase.

Source : The Jordan Islamic Bank, *Annual Reports*, 1979-1988.

creation of the voluntary reserve started only in 1981. In this year its ratio to the net profits was 15.5 per cent as is shown in Table 7.1.b. This ratio, however, reached 20 per cent in both 1984 and 1985 and then declined to 3.8 per cent in 1987, but increased again in 1988 to 12.9 per cent. On the other hand, the Bank started to build up its special reserve from 1985, when its ratio to the net profits was 9.8 per cent. Over the last three years, the ratio has, however, decreased from 15 per cent in 1986 to 3.7 per cent in 1987 and 4.4 per cent in 1988.

Another important factor of the shareholders' equity is the retained profits which are deducted from the net profits; the percentage of net profit that it represents is subject to the management's recommendation. Apart from 1980, when 34.5 per cent of net profit was transferred to retained profits, the ratio reached its peak in 1985, when it amounted to 26.5 per cent. In 1988, however, retained profits accounted for only 10 per cent of net profits. Altogether, the reserves and retained profits constitute a large share of net profits as Table 7.1.b shows. Their ratio to net profits increased from 48.6 per cent in 1984 to 66.3 per cent in 1985, as a result the net profits decreased from about JD 0..89 million to about JD 0.67 million. This decline in profits forced the Bank's management to be more cautious and to increase reserves and retained profits from JD 433.7 thousands in 1984 to JD 440.9 thousands in 1985, in spite of the decrease in net profits. In 1986, no major change was realized. In 1987, however, there was a remarkable drop in the reserves and net profits, when they fell from about JD 0.45 million in 1986 to about JD 0.32 million in 1987; hence their ratio to net profits declined from 60.3 per cent to 39.3 per cent in the respective years. This is in spite of the increase of net profits from about JD 0.77 million to about JD 0.83 million in the same years. The above decline may be understood as an action taken by the Management in order to maintain the same rate of dividends of 9 per cent distributed to shareholders over the 1984-87 period. This view may find support in the Management's behaviour in 1988. While the net profits increased from about JD 0.83 million in 1987 to about JD 1.2 million in 1988, the ratio of reserves and retained profits to them declined from 39.3 per cent to 37.3 per cent in the respective years, although they increased in absolute terms (see Table 7.1.b). Wisely, the increase was mainly in the voluntary reserve, rather than in other items, which jumped from only about JD 0.031 million in 1987 to about JD 0.15 million in 1988. To compensate for the severe decline in the Jordanian

Table 7.1.b : The annual reserves & retained profits, with their ratio to the Net profit in the Jordan Islamic Bank, 1980-1988 (JD 000)

Year	Net profit	Legal reserve*		Voluntary reserve		Special reserve		Retained profits		Total reserves &	Their ratio to
	(n.p)	JD	As % of n.p	JD	As % of n.p	JD	As % of n.p	JD	As % of n.p	retained profits	the net profit
1980	14	1.4	10	-	-	-	-	4.8	34.0	6.2	44.5
1981	321	32.1	10	49.8	15.5	-	-	-	-	81.9	25.5
1982	863	86.4	10	50.2	5.8	-	-	44.5	5.0	181.1	21.0
1983	594	59.4	10	80.0	13.5	-	-	39.1	6.6	178.5	30.1
1984	893	89.4	10	178.6	20.0	-	-	165.7	18.6	433.7	48.6
1985	665	66.5	10	133.0	20.0	65.0	9.8	176.4	26.5	440.9	66.3
1986	773	77.3	10	77.3	10.0	115.4	15.0	196.3	25.4	446.3	60.3
1987	825	82.5	10	31.1	3.8	30.5	3.7	180.0	21.8	324.1	39.3
1988	1158	115.8	10	150.0	12.9	51.4	4.4	115.4	10.0	432.4	37.3

* As the purpose of this Table is to examine the ratio of items to net profit, the value of legal reserve shown here does not include the increase of this reserve implemented in 1986 to meet the requirement of the capital increase stated earlier.

Source : The Jordan Islamic Bank, *Annual Reports*, 1980-1988.

dinar (JD) (mentioned earlier) and in order to compete and to prove themselves successful in a stagnant financial market suffering from low profitability, the Bank's management increased the dividends distributed from 9 per cent in 1987 to 12 per cent in 1988. The retained profits, therefore, were decreased from about JD 1.8 million to about JD 1.2 million in these two years. Since the various types of reserves had always met the conditions and the requirements of the Bank's Law, no major worries have been expressed by the Central Bank of Jordan in this regard. Advice from the Central Bank, however, is sometimes expected since the level of these reserves may affect both the degree of the Management's caution and the rate of dividends distributed by the Bank.

As far as the proportions of total reserves and retained profits to both shareholders' equity and total assets are concerned, Table 7.1.a shows their development over the period under review. While the ratio to the former increased steadily from only 0.3 per cent in 1980 to 42.17 per cent in 1988, their ratio to the latter did not exceed 0.84 per cent until 1985. In 1986, however, this ratio (the latter) peaked at 2.5 per cent as a result of the increase in capital and its legal reserve implemented in accordance with the Management's decision mentioned earlier, but it fell again to 1.96 per cent in 1988. On the other hand, although it is widely accepted that the shareholders' equity in commercial banks must be adequate enough to cater for the safety of deposits, the issue in Islamic banks is rather different. Both the shareholders' capital and deposits are liable, mostly, to the same level of risks. Thus, if the former even increased to a maximum point it would not prevent the latter from being exposed to risks. Notwithstanding this view, some Muslim scholars and economists argue that equity rights in an Islamic bank must be fairly large and adequate (See al Sadr (1980) and Hasan (1986)). This argument is mainly based on the following points:

- It is assumed that an Islamic bank is an investment-oriented institution which allocates large proportions of its funds to finance medium and long-term projects.

- It is the shareholder's funds which are assumed also to come first in funding investments involved in higher levels of risk. To this end, shareholders' equity should be maintained at a high level.

- In view of the fact that Islamic banks in interest-based economies cannot have recourse to the Central Bank as lender of the last resort, it is the increase of the shareholders' equity which may safeguard the bank against any potential shock.

- Increasing the bank's capital by issuing a greater number of shares will widen the owners-base of the bank, which will result in a stronger public-backed position for the bank. This also may contribute to the enlargement of the client-base of the bank, since shareholders naturally prefer to deal with their bank.

7.6.2 Deposits

1) Preliminary prospects:-

At the outset, it is worth mentioning that the term "deposits" when mentioned in the context of Islamic banking is metaphorically used, only as a concession to the modern-day banking terminology. In Islamic banks, funds which are paid by customers on various bases into all types of accounts do not conform with the principles of the *Wadiah* (a safekeeping deposit) as prescribed by the Islamic *Shariah.*

Moving from the general to the specific, the following pages will focus on the deposits of the Jordan Islamic Bank as a main source of its funds.

As a result of the inflationary pressures that the Jordanian economy suffered during the late 1970s, it was found that the real rate of interest on deposits offered by conventional banks in 1979, when the Jordan Islamic Bank entered the frey, was negative. In 1979 and 1980, this rate was -7.7 per cent and -4.4 per cent respectively (al-Khatib, 1987, p.113). Under these circumstances, the Jordan Islamic Bank started operations with the expectation of attracting huge deposits.

However, Jordanians, in fact, tend to be conservative, especially in financial matters. They prefer to adopt a "wait and see" approach, as Wilson (1987b) put it, before depositing their own funds. Thus, the Bank's expectations met with a limited public response and most of the initial depositors were the shareholders.

Therefore, the volume of deposits in the first three years was not considerable at all. They were only about JD 12.5 million and JD 36.8 million in 1980 and 1982 respectively. The rapid growth of the Jordan Islamic Bank's deposits took place after 1982, and within two years they had more than doubled to reach JD 89.48 million in 1985. This rapid growth continued until they reached JD 174.43 million and JD 194.96 million in 1987 and 1988. Although the significance of such a growth of the JIB's deposits is to be examined in the next chapter, it is important to notice at this stage that they constitute the major source of funds for the Bank. Over the last decade, their share in total liabilities has always exceeded 80 per cent, its high point being in 1985, when it reached 89.6 per cent; this is against 87.6 per cent in 1988 (Table 7.2).

2) The types of deposits:-

There are three main types of deposit accounts offered by the Jordan Islamic Bank; trust accounts, joint investment accounts and specified investment accounts. The following classification highlights the main features of each of these types of accounts and indicates any restriction that may be placed on the account holder.

i) Trust accounts:-

Trust accounts include two types of account, namely the current account and the demand deposits account. Among all Islamic banks, the Jordan Islamic bank is perhaps the only one that differentiates between these two sorts of account. Islamic banks normally offer a current account which they also refer to as a demand deposit account. However, a demand deposit account at the Jordan Islamic Bank equates with the non-investment savings account at the other Islamic banks. Unlike the demand deposit account, the current account in the Jordan Islamic Bank is operated in the same way as it is in the conventional banking system. In trust accounts, the bank accepts deposits from its customers for safekeeping, although they are deemed loans from the public to the Bank, in order to justify their use legally (See Homoud, 1981). With the permission of the customers, the Islamic bank is allowed to use the outstanding balance of the current account's funds to finance short-term free loans to other customers, and to finance projects for profit generation, provided that the profit made belongs

Table 7.2 : The liabilities of the Jordan Islamic Bank, 1980-1988 (JD million & percentages).

Year	Shareholder's equity		Client's deposits*		Bank deposits		Cash margins		Misc. provisions		Other liabilities		Total
	JD	%	JD	%	JD	%	JD	%	JD	%	JD	%	liabilities
1980	2.01	13.0	12.5	80.8	0.01	0.06	0.45	2.9	0.12	0.8	0.38	2.5	15.47
1981	3.08	9.8	26.18	82.8	0.01	0.04	0.93	2.9	0.48	1.5	0.96	3.0	31.61
1982	4.27	9.4	36.76	81.2	0.17	0.38	1.20	2.6	1.27	2.8	1.67	3.6	45.24
1983	4.40	6.2	61.42	86.0	0.56	0.79	1.60	2.2	1.59	2.2	1.92	2.6	71.49
1984	4.79	4.7	89.48	87.6	0.92	0.90	1.63	1.6	2.52	2.5	2.75	2.7	102.09
1985	5.07	4.0	113.57	89.6	0.65	0.51	1.11	0.9	2.83	2.2	3.55	2.8	126.77
1986	9.99	6.2	142.58	88.2	0.31	0.19	1.66	1.0	2.71	1.7	4.42	2.7	161.66
1987	10.12	5.1	174.43	88.4	2.07	1.04	1.75	0.9	3.56	1.8	5.49	2.7	197.42
1988	10.38	4.66	194.69	87.59	3.07	1.38	3.16	1.4	4.28	1.92	6.73	3.0	222.58

% The percentages to total liabilities.

* Including specified investment deposits.

Source : The Jordan Islamic Bank, *Annual Reports*, 1980-1988 (Author's calculation).

entirely to the bank. This procedure is agreed upon by the majority of modern Muslim scholars and jurists, and was supported by the first conference of Islamic banking held in Dubai in 1979.

Formalities of opening a trust account (and other accounts) are simple. There is no need for a reference - the customer's name, address and occupation, together with a specimen signature and an initial deposit being all that are needed.

Unlike those holding demand deposit accounts, current account holders are issued with cheque books and provided with bank statements which are regularly sent to them to show their transactions. However, a pass book is provided for those with demand deposit accounts which provides a convenient record of all transactions. In this type of deposit, funds may be withdrawn on demand by calling at the branch where the account is maintained. Funds can be deposited in trust accounts and withdrawn on demand subject to no conditions. Trust accounts should always be maintained in credit; no overdraft facilities are provided by the Jordan Islamic Bank, although such a service was recommended by the above mentioned Conference, based on the opinion that, when it is in effect, an overdraft can be seen as a loan from the bank to the depositor.

Bank charges may be made for operating the current account based on the costs of any transactions relating to, or passing through, the account. For the legal justification of such a practice (see al Sadr (1980) and Wahba (1977)).

ii) Joint investment accounts:-

These represent the main form of Islamic bank accounts, although their types and conditions may differ from one Islamic bank to another. The Jordan Islamic Bank offers three kinds of investment account on the the principles of the joint *Mudaraba* (i.e. involving more than two parties). Under this kind of arrangement, the bank acts as the "entrepreneur" and the customer as "the provider of capital". Both parties also agree on how to distribute the profits, if any are generated by the bank from the investment of the funds. The ratio of distribution of profits may vary from time to time. At present, the Bank offers the distribution in the ratio of 65 per cent to the customers, 25 per cent to the Bank and 10 per cent allocated to the "Investment Risks Provision".

The characteristics and the conditions of each of these joint investment accounts are discussed briefly below.

a) Fixed-term deposit accounts: Customers with these accounts, deposit their funds looking for investment opportunities which may yield a legitimate return (profit). They authorize the Bank to invest and manage their funds as it wishes, in accordance with the absolute *Mudaraba* principles (see chapter 4), as prescribed by the *Shariah*. In this account the deposited money must stay in the Bank for at least one year in order to be eligible for profit. Depositors are not allowed to withdraw their money before this period has elapsed but if they do so, they will not take any profit at the end of the year. Moreover, depositors who withdraw their money before the realization of profits at the end of the financial year will participate in the bearing of any loss resulting from the joint investment account. Such a procedure, however, remains legally questionable unless these depositors have the right to participate in the realized profits. The minimum amount of money that can be accepted from a customer in a fixed-term deposit account is JD 500 in the case of a local currency account and JD 1,000 if it is a foreign currency account. The maximum amount of a deposit is subject to the recommendation of the Bank's management. Customers can deposit their money at any time of year, and become entitled to profit from the beginning of the month following the date of depositing. The period of the fixed-term deposit is automatically renewable on the due date for a similar period unless the customer notifies the Bank in writing, one month before the expiry date of the deposit. 90 per cent of the balance of the fixed-term deposits participate in the profits realized from the investment activities of the Bank.

b) Notice-deposit accounts: The charactersitics and conditions of this type of investment account are very close to those of the fixed-term accounts, mentioned above, with the exception of the three following points:

- No money can be drawn from this account without prior notice of three months. This means that the money must stay in the Bank for at least three months in order to participate in profit.

- Although a cheque book is not issued on this type of account as is the case with the fixed-term account, the client may benefit from other facilities within the limit of the prior notice condition. Where a customer, for example, maintains both a notice-deposit and a current account at the same branch, funds can be transferred from one to another, taking into consideration the notice condition, so that if notice-deposit account funds are required to pay a bill, the appropriate sum may be switched to the current account and a cheque issued.

- 70 per cent of the balance of the notice-deposit accounts participate in the realized profits at the end of the financial year.

c) Savings deposit accounts: The original and most widely accepted idea of a savings account in Islamic banks is that funds are deposited for safe custody rather than profit, and that they are readily accessible, as is the case of the current account. Some Islamic banks, however, offer two types of savings account: non-investment savings account and investment savings account. While both the Dubai Islamic Bank and the Kuwait Finance House, among others, maintain these two types of accounts, the Jordan Islamic Bank is perhaps the only one in which savings accounts operate only as investment accounts. They are designed to appeal to "small savers", and to this end the minimum amount acceptable for a savings deposit is set at JD 100. The Bank does not provide cheque books for the account, but the customer can withdraw from his account by calling at the Bank from one JD up to JD 10 a day without prior notice. However, if the withdrawal will exceed this amount, the customer must notify the Bank ten days before the withdrawal date. Similar to those with demand deposit accounts, holders of saving accounts are issued with a passbook to record all transactions passing through their accounts. Savings deposits participate in the realized profit in the ratio of 50 per cent of their outstanding balance.

iii) The specified investment account:-

In this type of account, the account holder may choose any specific project or particular industry for the investment of his deposited funds. The authorization given to the Bank to invest and manage the client's funds will thus be in

Table 7.3.a : The development of the different types of the clients deposits in the Jordan Islamic Bank, 1980-1988 (JD million).

Year	Trust accounts		Joint investment accounts								Specified inv. accounts		Total deposits
			Saving deposits		Notice deposits		Fixed term deposits		Total inv. deposits				
	JD	%	JD	%	JD	%	JD	%	JD	%	JD	%	
1980	4.85	-	1.10	-	4.10	-	1.60	-	6.80	-	0.85	-	12.49
1981	12.21	152.0	1.86	70.0	8.02	95.8	3.23	102.0	13.12	92.9	0.85	-	26.18
1982	16.38	34.1	3.27	75.3	11.53	43.7	4.65	44.0	19.45	48.2	0.92	8.7	36.76
1983	20.73	26.5	4.90	50.0	13.49	17.0	19.45	318.0	37.84	94.6	2.85	208.9	61.42
1984	22.30	7.8	6.83	75.0	15.03	11.5	38.71	99.0	60.57	60.1	6.61	131.6	89.48
1985	23.75	6.5	8.06	18.1	15.88	5.6	55.18	42.5	79.12	30.6	10.7	62.0	113.57
1986	26.64	12.2	10.29	27.6	16.33	2.9	74.35	34.7	100.97	21.9	14.97	39.8	142.58
1987	31.23	17.2	12.53	21.8	16.46	0.8	98.29	32.2	127.27	26.3	15.92	6.4	174.43
1988	35.08*	12.3	14.06	12.2	18.40	11.8	110.26	12.2	142.72	15.45	17.15	7.7	194.96

% Growth rate

* JD 32.09 current accounts and JD 2.98 demand-deposit accounts.

Source : The Jordanian Islamic Bank, *Annual Reports*, 1980-1988. Data relating to the types of joint investment account and trust accounts in 1988 were provided by the Bank's management.

accordance with the principles of restricted *Mudaraba* in Islamic *Shariah*. The balance of the account remains in credit until the liquidation of the transaction in which the funds are invested. Profits pertaining to the specified investment are distributed between the Bank and the account holders according to an agreed percentage. If there is a loss, it will have to be borne entirely by the account holder, unless it results from wilful acts of negligence on the part of the Bank.

3) Deposit trends:-

Deposit trends in the Jordan Islamic Bank are shown in Tables 7.3.a,b and c. The Tables compare the rates of growth of the different types of deposits as well as their relative importance. They indicate the increasing importance of current and demand deposits in the first three years. This reflects the caution and reluctance of people to deposit their money in investment accounts, on the one hand, and their enthusiasm to deposit their funds in an interest-free bank, on the other. Within one year, trust accounts increased almost three fold when they amounted to JD 12.21 million in 1981 against JD 4.85 in 1980 (Table 7.3.a). Their share in total deposits, hence, rose to 46.6 per cent against 38.8 per cent in the respective years. Less impressive growth was also achieved in 1982, though there had been an evident decrease after then; their contribution to total deposits therefore, fell to 17.9 per cent and 18 per cent in 1987 and 1988 respectively (Table 7.3.b). Unlike demand-deposit accounts, current accounts are the most widely used by the trust account's clients. Data available for 1988 indicates that the latter accounted for 16.5 per cent of total deposits against only 1.5 per cent for demand deposits. This is mainly due to the cheque service which makes the withdrawal of money more flexible and much easier than the case of demand deposits. At the same time as the shrinking in trust accounts in the Jordan Islamic Bank, there was substantial growth in the joint investment accounts. Despite the difficult market conditions in which the Jordan Islamic Bank found itself, investment deposits showed a very creditable increase since 1983. In that year, their contribution to total deposits amounted to 61.7 per cent against 52.7 per cent in 1982. This ratio reached its highest point of 73.1 per cent in 1988 when total investment deposits amounted to JD 142.72 million against only JD 6.8 million in 1980. Although there were several profit realizations reflected in appropriate rates of return on deposits and dividends, the Jordan Islamic Bank has never experienced the substantially high levels of profits as has been the case in many Islamic banks. Thus, the substantial growth of the Bank's total deposits in general, and investment deposits in particular, cannot fully be explained by profits. Perhaps, each type of investment deposit has its own factors which may account for its development.

Table 7.3.b : The relative importance of the different types of client deposits in the Jordan Islamic Bank.

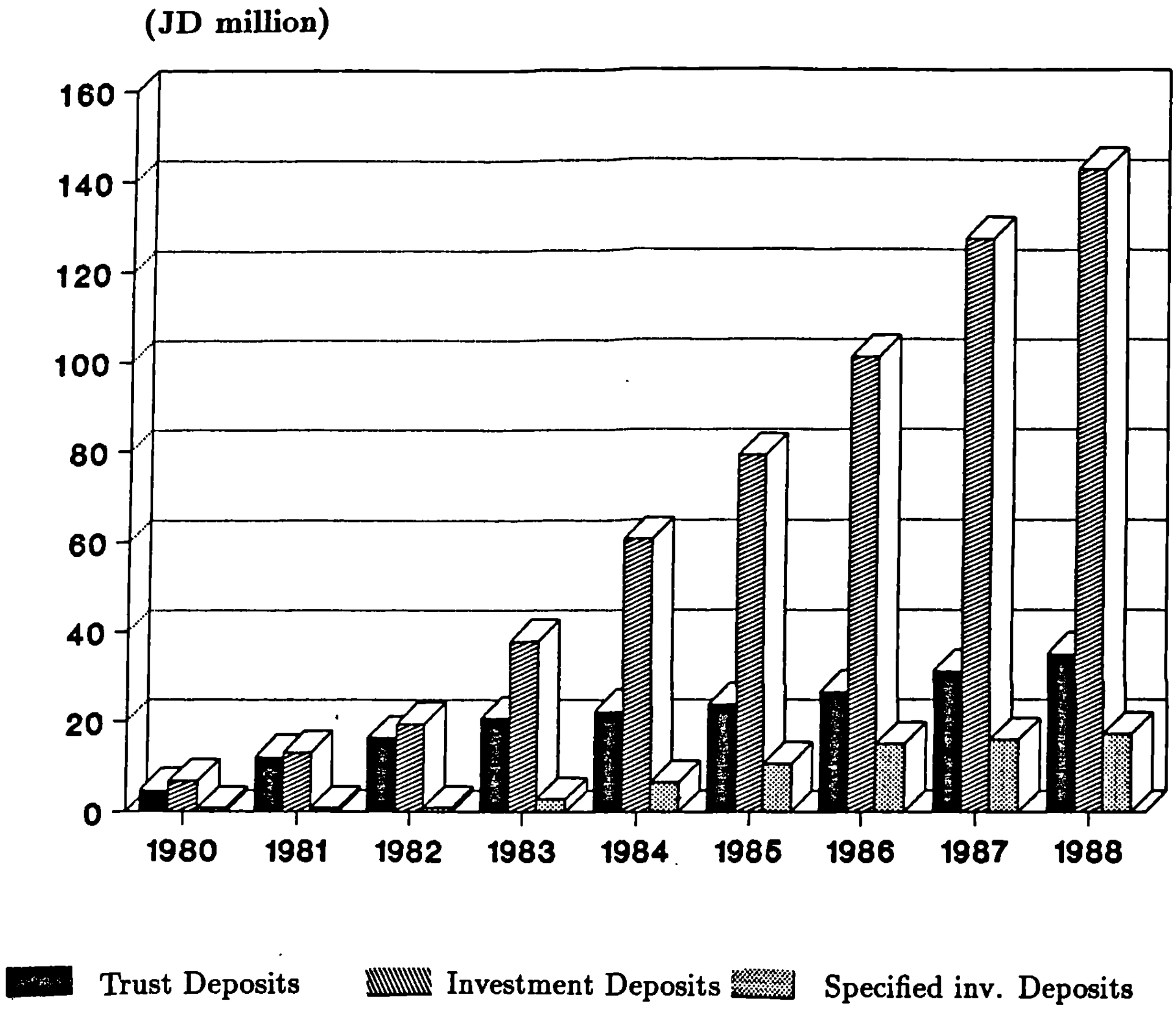
Account type	1980	1981	1982	1983	1984	1985	1986	1987	1988
Trust accounts :	38.8	46.6	44.6	33.7	24.9	21.0	18.7	17.9	18.0
Current accounts	-	-	-	-	-	-	-	-	16.5
Demand deposit acc.	-	-	-	-	-	-	-	-	1.5
Joint investment acc.:	54.4	50.1	52.7	61.7	67.7	69.7	70.8	72.9	73.1
Time deposits	12.8	12.4	12.7	31.7	43.3	48.6	52.1	56.3	56.5
Notice deposits	32.8	30.6	31.0	22.0	16.8	14.0	11.5	9.4	9.4
Saving deposits	8.8	7.1	8.9	8.0	7.6	7.1	7.2	7.2	7.2
Specified investment acc.:	6.8	3.2	2.5	4.6	7.4	9.4	10.5	9.1	8.8
Totals	100	100	100	100	100	100	100	100	100

- data not available

Source : Calculated from Table 7.3.a

However, at this stage of analysis, it can be said that at a time when Islamic banking (as a manifestation of the contemporary Islamic revival) is attracting considerable attention it is important to recall that the Jordan Islamic Bank was, until 1983, the sole financial institution in Jordan to accept deposits on an interest-free basis. It perhaps continued to be so even after that date in which the short-lived Islamic Investment House was established, since the latter confined its operations to its head office in Amman and collapsed in 1986. For the whole period under review, saving deposits remained at a relatively low level as their contribution to total deposits fluctuated between 7.1 per cent and 8.9 per cent,

Chart 7.1 : JIB Deposit Growth.



Source : The Jordan Islamic Bank, *Annual Reports*, 1980-1988.

although they increased from only JD 1.1 million in 1980 to JD 14.1 million in 1988.

The results for the notice-deposit accounts showed a substantial decline in their share of total deposits from 32.8 per cent in 1980 to only 9.4 per cent in 1988, although they increased insignificantly in absolute terms from JD 4.1 million to JD 18.4 million in the respective years. In 1987 and 1988 they accounted for 12.9 per cent of total investment deposits (Table 7.3.c).

Table 7.3.c : The types of the joint investment deposits of the Jordan Islamic Bank, 1980-1988 (percentages).

Year	Saving deposits	Notice deposits	Fixed term deposits
1980	16.1	60.4	23.5
1981	14.2	61.2	24.6
1982	16.8	59.3	23.9
1983	13.0	35.6	51.4
1984	11.3	24.8	63.9
1985	10.2	20.1	69.7
1986	10.2	16.2	73.6
1987	9.8	12.9	77.3
1988	9.8	12.9	77.3

Source : Calculated from Table 7.3.a.

The popularity of fixed term deposits among investment deposits is clearly evident. Within three years they achieved more than a twelve fold increase, when they rose substantially from only JD 1.6 million in 1980 to JD 19.5 million in 1983, accounting for 31.7 per cent of total deposits. This increase continued steadily over time until they reached JD 110.26 million in 1988. By this year, their contribution to both total deposits and investment deposits reached a record level. While their ratio to the former was 56.5 per cent, their share to the latter was found to be 77.3 per cent. In fact the substantial increase in this type of deposit can be attributed basically to the management's decision taken in 1983, to accept fixed-term deposits at any time of the year. That is to say, the Bank abandoned its earlier policy (started in 1979) of accepting this type of deposit only at the end of the financial year. Another important factor was the decision also taken by the management in 1983, which allowed the Bank to accept investment deposits (both fixed-term and notice deposits) in foreign currencies. The profit incentive represented by the highest percentage they earn of the realized profit (90 per cent of its outstanding balance are eligible for profits) is another important factor accounting for the predominance of the fixed-term deposits. Since the main reason for the clients to hold an investment account is the earning of profit, they will naturally choose the high profit accounts as first priority to deposit their money in.

The specialized investment deposits in the annual reports of the Jordan Islamic Bank are not added to total clients deposits, yet there is a case for arguing that they should be considered. It is true that they are not included in case of calculating both the liquidity and the credit advance ratios defined by the Central Bank but they are still to be seen as savings collected by the Bank. Their addition to the clients' deposits will indicate more comprehensively the real role played by the Bank in attracting savings and mobilizing financial resources to be utilized for the benefit of the economy of the country.

Over the period under consideration, the specialized investment deposits collected by the Bank increased from only JD 0.85 million in both 1980 and 1981 to JD 17.15 million in 1988 (Table 7.3.a). However, their contribution to total deposits declined. In the first three years, it slowed down from 6.8 per cent in 1980 to 2.5 per cent in 1982 (Table 7.3.b). Nevertheless, since the beginning of 1983, they began to rise significantly achieving a more than threefold increase and accounting for 4.6 per cent of total deposits. As their value continued to increase from JD 2.8 million in 1983 to JD 14.9 million in 1988, their ratio to total deposits also increased from 4.65 to 10.5 per cent over the same period.

However, this ratio fell again in 1987 and 1988 to 9.1 per cent and 8.8 per cent respectively, in spite of their rise in absolute terms.

The main reason behind this increase in the specified investment deposits shown above was the undertaking of the house building projects of *al Rawdha suburb*, which was financed mainly from the specified investment deposits.

4) Maturity-structure deposits:-

The maturity structure of deposits is vital in differentiating between short period deposits and long period deposits and the proportion of each to total deposits. Such a classification will help the Bank in allocating funds efficiently among investment projects. That is, it enables the management to place into long term investments those deposits that are likely to remain for a long period with the Bank.

Only the maturity structure of fixed-term and notice deposits is provided by the Bank. This structure is classified into four periods, shown in Table 7.4. The magnitude of each of these four categories is to be examined in relation to the clients' deposits only. The specified investment deposits are excluded in this case as they are already allocated to specified projects. Since the over all level of the Bank's financing operations is, in both the short and the long terms, affected by the deposits' maturity, the following comments are to be made on Table 7.4:

- Both the trust and savings accounts are excluded from the management's categorization of the maturity structure of deposits based on the view that they are subject to immediate withdrawal. For clarity, the two following points are to be considered:
  - It is a matter of fact that trust account deposits are basically accepted for safekeeping rather than investment. The opinion that the Bank may use these deposits on the authorization of depositors to generate profit for itself (as mentioned earlier) is rather hypothetical and impractical. If the Bank did so, it would be vulnerable to bankruptcy; hence, for the safety of its financial position the Bank must keep these deposits as 100 per cent liquid.

Table 7.4 : The maturity structure of fixed-term deposits and notice deposits in the J.I.B at the end of years 1980-1987.

Year	Deposits due < 3 months	Deposits due 3-6 months	Deposits due 6-9 months	Deposits due > 9 months
1980	4.10	-	-	1.60
1981	8.02	-	-	3.23
1982	11.53	-	-	4.65
1983	13.48	-	-	19.45
1984	38.30	4.76	3.70	6.99
1985	32.53	8.75	10.89	18.90
1986	34.30	14.81	16.80	24.78
1987*	26.30	17.47	28.05	26.47

* Fixed term deposits only

Source : Provided by the Jordan Islamic Bank's management.

- Savings deposits usually come from small savers who wish to earn profit but, at the same time, they may call for their money frequently to meet their everyday needs. Thus, the management often hold a large proportion of these deposits, if not all of them, liquid to maintain a satisfactory level of liquidity. This assumption needs to be tested further when examining the liquidity position of the Jordan Islamic Bank in the next chapter.

- It is apparent from Table 7.4 that up to 1983, all the fixed-term deposits were due after nine months, whereas all notice deposits were due during three months (See the value of these deposits in Table 7.3.a). This may have been a result of the early policy of the Bank not to accept these deposits except at the end of the financial year as mentioned earlier.

- The Table shows an extremely unfavourable drop in 1984 in the deposits due after nine months. This also can be understood as a result of the Bank's resolution taken in 1983, stipulating that fixed-term deposits can be accepted at any time of the year contrary to the above mentioned policy where acceptance of fixed-term deposits was limited to the end of the year.

From the Table, it can be concluded that deposits which became due after nine months amounted to 19.4 per cent of total deposits in 1986. This is against 8.4 per cent in 1984, a percentage which was curbing the Bank's ability to employ its resources for long periods and consequently hindering the investment policies of the Bank.

One important point to be noted here is the proportion of the deposits due after nine months to the fixed-term deposits. From 1987 data, which represents only the fixed-term deposits, it can be concluded that this proportion is only about 27 per cent. In response to this, some may argue that 63 per cent of fixed-term deposits do not satisfy their conditions to remain for one year; they, instead, are subject to withdrawal by the depositor even before 9 months and, hence, the Bank will take their share in profits. However, this is very naive. It assumes that the total fixed-term deposits are deposited at the end of the year which is not necessarily true. Deposits with other maturities must also be considered. If a deposit is due after six months from the end of December 1987, it does not mean that it will not complete its minimum period, unless it is proven that it was deposited after the end of June 1987.

7.6.3 Bank Deposits

In addition to the client's deposits, there are also bank deposits in the Jordan Islamic Bank. These are the deposits that the Bank accepts according to an agreement with domestic and foreign banks without paying or receiving interest on either side.

These deposits constitute an insignificant share in the Bank's liabilities, as the maximum amount reached by them was JD 3.07 million in 1988, accounting for 1.38 per cent of total liabilities (Table 7.2).

One important point to notice is that JD 2.98 million of these deposits were raised from foreign banks, while domestic banks provided only JD 0.09 million; a matter which mirrors two important facts: the first is that most of the funds raised in this way are used in financing imports through *Murabaha* operations as mentioned earlier. The second is the absence of a developed inter-bank capital market in Jordan as stated in the previous chapter.

7.6.4 Cash Margins

These represent the funds collected from customers as collateral for letters ofcredit and letters of guarantee which are issued for them by the Bank. The value of these funds increased from JD 0.45 million in 1980 to JD 1.75 million in 1987. Against the extremely unfavourable climate Jordan suffered since early 1988 (see Chapter 6), these margins had more than doubled when they amounted to JD 3.16 million by the end of 1988. Consequently, their share in total liabilities increased from only 0.9 per cent in 1987 to 1.4 per cent in 1988, even though they always represented a tiny proportion of total liabilities (Table 7.2).

7.6.5 Miscellaneous Provisions

This item includes the investment risks provision, income tax provision and the employees indemillionities provision. From 1983, their share in total liabilities decreasingly fluctuated between 2.8 per cent in that year to 1.7 per cent in 1985. Since then the ratio started to rise until it reached 1.92 per cent in 1988 when their value reached its high point of JD 4.28 million (Table 7.2). Of special interest among these provisions is the investment risks provision. According to the Bank's law, this provision is deducted annually from net profits as 20 per cent until it becomes equivalent to 50 per cent of the Bank's capital and then its percentage will be reduced to 10 per cent of net profits until it becomes equivalent to the capital. At that point, no more provision will be taken from profits. It is to note here, that both the Bank and the depositors are carrying the burden of such provision and at present, only 10 per cent of the Bank's net profits are dedicated to this.

In case the Bank is dissolved and liquidated the fund of any remaining provisions is directed to the State *Zakah* fund.

7.6.6 Other Liabilities

This item includes shareholders' dividends, profits to be distributed to holders of joint investment deposits and the staff merit rewards. It also includes certified cheques and other secondary liabilities. The total amount of these liabilities increased from only JD 0.38million in 1980 to JD 6.73 million in 1988. However, their share in total liabilities remained low, though it increased steadily from 2.5 per cent to 3 per cent in the respective years (Table 7.2).

7.7 The Uses of the Bank's Funds

As the Bank cannot earn interest by lending its money, it has to utilize its resources in investment to earn appropriate profit, not only for the Bank itself but also for the depositors holding investment accounts. The uses of the Bank's funds are expressed in the assets side of its balance sheet and will be examined for the period from 1980 to 1988. They can be discussed under the same categories provided by the Bank's balance sheet as follows.

7.7.1 Cash in Hand and at Banks

This asset consists of three main items:-

i) Cash money: This represents a certain amount of banknotes and coins held by the Bank's branches and the Head Office to meet demands for withdrawals by customers.

ii) Cash balances at the Central Bank of Jordan: The Banking Law in Jordan requires all licensed banks, including the JIB, to keep 9 per cent of their clients' deposits in JD in non-interest earning deposits at the Central Bank; that is, as a cash ratio deposit. While 60 per cent of the balance within the Central Bank takes the form of a 2 days notice deposit, the other 40 per cent is held as a demand deposit.

iii) Balance with local banks and banks abroad: This item is also a non-interest yielding asset for the Bank, as it is Islamic. Together with the above two items, it constitutes a non-profit earning asset for the Jordan Islamic Bank.

The development of the Bank's assets is shown in Table 7.5. Over the period under consideration, cash in hand and at banks increased from JD 6.59 million in 1980 to JD 74.76 million in 1988, achieving an increase of more than elevenfold.

While their ratio to total assets dropped from 42.6 per cent in 1981 to 28.2 per cent in 1980, it remained almost the same in 1987 and 1988, when it was found to be 33.4 per cent and 33.6 per cent respectively. The drop in this asset in 1982 was meant to result in the rise of the investments of the Bank. In the same year, investments peaked at JD 26.47 million, accounting for 58.5 per cent of total assets against 44.9 per cent in 1981 (Table 7.5).

It can be seen from Table 7.5 that cash in hand and at banks was the second most important item in the Bank's balance sheet over the *1980-1988* period. This relatively high proportion of cash items mirrors the Bank's policy concerning liquidity, which will be further highlighted in the last section of this chapter and practically evaluated in the next.

7.7.2 The Investment Portfolio

Since the Bank does not deal in bonds or any other interest-earning securities, its investment portfolio comprises only company stock. To compensate for its not being able to hold Government securities as liquid assets (which are eligible for discount at the Central Bank), the Bank's investment in shares was regarded as a liquid item in calculating the liquidity ratio defined by the Central Bank. Unlike the Jordan Islamic Bank, when listing the assets on the balance sheet many Islamic banks itemize their investment portfolio as a part of the financing investments based on the *Musharaka* or any other technique. The idea behind this is that in cases where trading in and holding shares of modern companies account for a high proportion of total investments, Islamic banks attempt to show that they maintain a high percentage of *Musharaka* investments as is expected from them.

In fact, this is untrue. Shares can mainly be purchased and sold on the stock market in which Islamic banks may burn their fingers if they become over-exposed to its speculative transactions. Fortunately for the Jordan Islamic Bank,

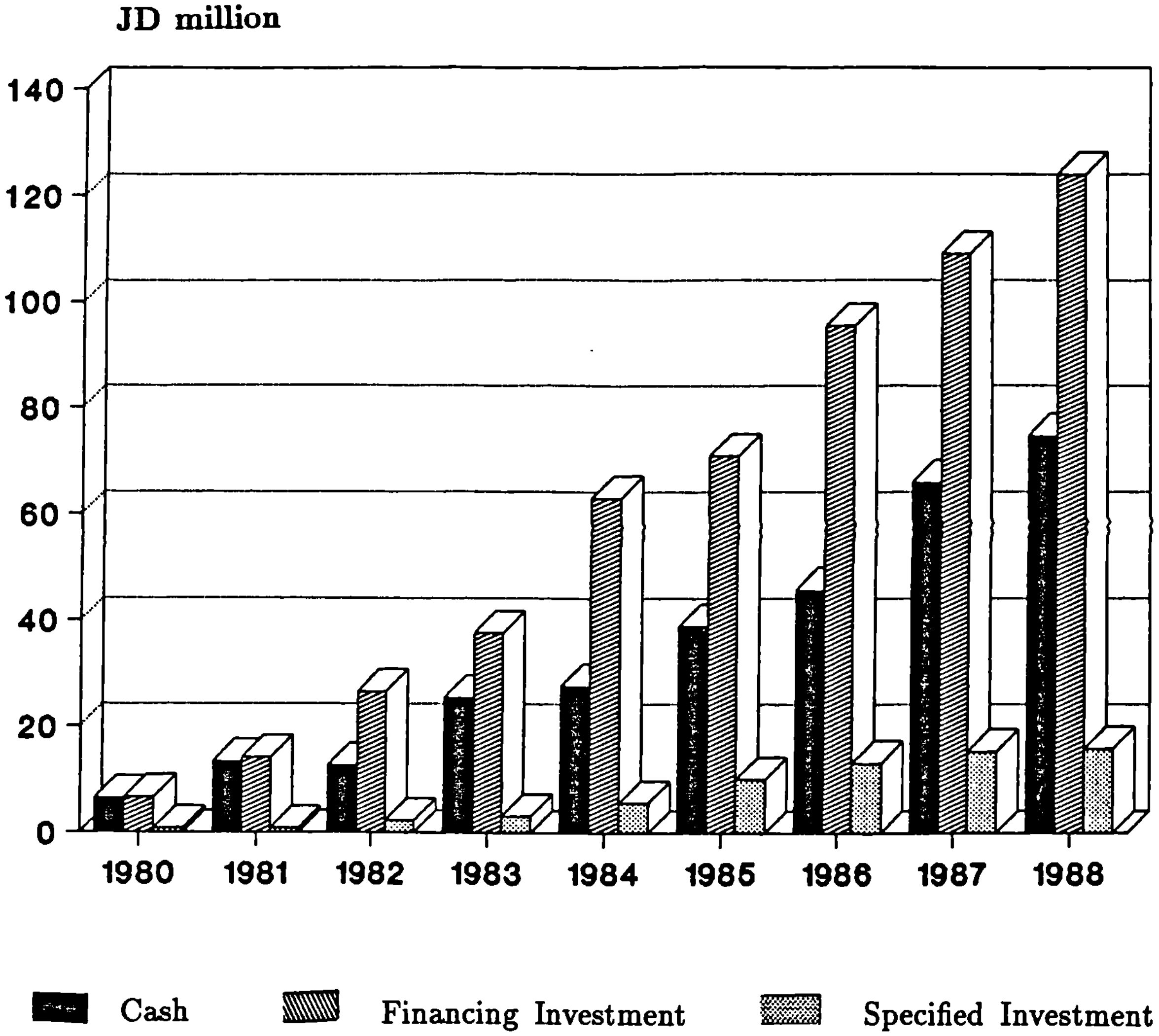
Table 7.5 : The assets of the Jordan Islamic Bank, 1980-1988 (JD million & percentages).

Year	Cash in hand and at banks		Securities portfolio		Interest-free loans & bills discounted		Financing investments		Specified investments		Fixed assets		Other assets		Total assets
	JD	%	JD	%	JD	%	JD	%	JD	%	JD	%	JD	%	
1980	6.59	42.6	-	-	0.04	0.3	6.75	43.6	0.83	5.4	0.60	3.8	0.66	4.3	15.47
1981	13.47	42.6	0.10	0.3	0.05	0.2	14.2	44.9	0.88	2.8	0.81	2.6	2.08	6.6	31.61
1982	12.8	28.2	0.18	0.4	0.15	0.3	26.47	58.5	2.30	2.7	1.81	3.9	2.81	6.2	45.24
1983	25.44	35.6	0.29	0.4	0.38	0.5	37.60	52.6	3.15	4.4	2.70	3.8	1.93	2.7	71.49
1984	27.56	27.0	0.30	0.3	0.25	0.2	63.01	61.7	5.64	5.5	3.84	3.8	1.49	1.7	102.09
1985	38.86	30.6	0.30	0.2	0.29	0.2	71.01	56.0	10.11	8.0	4.87	3.8	1.34	1.1	126.77
1986	45.77	28.3	0.32	0.2	0.37	0.2	95.46	59.0	13.19	8.2	4.78	2.9	1.80	1.1	161.66
1987	65.96	33.4	0.32	0.2	0.31	0.2	109.00	55.2	15.35	7.8	4.66	2.4	1.81	0.9	197.42
1988	74.76	33.6	0.25	0.1	0.45	0.2	124.15	55.8	15.89	7.1	4.88	2.2	2.19	0.1	222.58

% The ratio to total assets

Source : The Jordan Islamic Bank, *Annual Reports*, 1980-1988 (Author's calculations).

Chart 7.2 : JIB Major Assets.



Source : The Jordan Islamic Bank, *Annual Reports*, 1980-1988.

its investment portfolio represents a tiny proportion of total assets. For example, in 1988 it represented only 0.1 per cent of total assets.

7.7.3 Benevolent Interest-Free Loans and Discounted Bills

Benevolent loans in this item represent that sum of money extended from the bank's funds to needy people on an interest-free basis (*Qard Hasan*). In 1985, a benevolent loan fund was set up in the Jordan Islamic Bank with the aim of accepting repayable deposits from people who wish to offer them to needy people as interest-free loans. The Bank also discounts short-dated trade or commercial bills for its customers without recovering any interest or even a service charge. They also provide a method for short-term lending on an interest-free basis for business customers of the Bank.

Table 7.5 indicates that this asset was always insignificant. In 1982, however, it began to increase notably as the Bank started to extend interest-free loans from that date. In 1983, it rose to JD 0.38 million but then started to fluctuate until it peaked at JD 0.45 million in 1988. For most of the years during the considered period its contribution to total assets was 0.2 per cent. The main reason behind the fluctuation of this asset is that the amount of interest-free loans offered by the Bank depends upon the management's own discretion; when an applicant asks for a loan, the Bank examines his request in the light of the priority scale drawn up by the Bank itself and decides whether to pay him or not.

7.7.4 Investment Financing

This is the largest asset in the Bank's balance sheet and includes all forms of Islamic financing adopted by the Bank. Table 7.5 shows that the amounts of financing extended by the Bank increased from only JD 6.7 million in 1980 to JD 124.4 million in 1988. Its contribution to total assets hence rose from 43.6 per cent to 55.8 per cent in the respective years. This rapid growth indicates that the Bank's tendency over the period was to emphasise its basic function as an interest-free financial institution for finance and investment. The Bank invests its available resources by any of the following major methods:

1) *Musharaka* financing:-

Through the *Musharaka* arrangement, the Bank undertakes project financing. Under this method, the Bank together with the initiator or initiators of the relevant project will provide the entire financing for the project in agreed proportions for an agreed period of time. The profits generated from the project will be distributed according to a proportion determined in advance. The proportion need not coincide with the ratio of participation in capital. There is no fixed formula for profit-sharing and each case is dealt with by its own merit. In the event of a loss, however, all parties bear the loss in proportion to their shares in the financing (See Chapter 4).

The *Musharaka* operations in practice vary in duration from a few weeks to a few months or, if need be, can go on for years. In the case of medium and long-term operations a decreasing form of participation is usually agreed on, whereby the ownership of the whole project passes to the client after an agreed period of time, during which the Bank is expected to have retrieved its principal plus a suitable share of profit. This type of participation is the most prominent application of *Musharaka* adopted by the Jordan Islamic Bank.

2) *Mudaraba* (*Qirad*):-

Mudaraba is another technique of project financing. Under the principles of this arrangement of investment, the Islamic bank is the provider of the capital and should provide all the financing (100 per cent) for the relevant project. The initiator of the project is the "entrepreneur" who contributes only his managerial efforts or labour (See Chapter 4). The profit generated from the project, if any, will be shared according to an agreed proportion. In case of financial loss resulting from normal business conditions, the Bank bears all the losses. In the Jordan Islamic Bank's practice, however, the *Mudaraba* contract stipulates that in the case of loss, this loss will be borne proportionally by the two parties involved in the *Mudaraba* (the Bank and the *Mudarib*), according to each one's share in the *Mudaraba* funds. This implies that the *Mudarib* may participate in the *Mudaraba* capital. If so, the operation is deemed to be *Musharaka* rather than *Mudaraba*. As stated above, however, in a *Mudaraba* procedure the Bank contributes all the capital and hence bears all the financial risks. These financial risks justify the Bank's claiming its share in the profits. The client in normal business conditions loses nothing but his effort, but is held responsible for the loss of capital, if it results from his negligence or wilful actions. To guard against this, the Bank may require security from the client.

In conformity with the very nature of the *Mudaraba* contract, it appears from the regulations of the Jordan Islamic Bank that the latter does not interfere in the management of the *Mudaraba* projects. But at the same time, it has the right to carry out the follow-up and monitoring tasks.

3) *Murabaha*

The Bank also practices the financing of the acquisition of assets under the principle of *Murabaha*, i.e. cost plus or mark up (See Chapter 4). The practice of this procedure in the Jordan Islamic Bank started in the early months of its operations. At present, *Murabaha* is most commonly used by the Bank in financing a wide range of transactions which can be highlighted as follows:

- *Murabaha* sale of movable commodities which can be pledged (such as cars): In this case, the customer submits an application for the purchase of the commodity on a *Murabaha* basis to the Bank branch and signs a "*Murabaha* contract for the purchase order". Information included in the contract comprises information about the client; the specifications of the required good; the profit ratio; conditions of payment; and the date and the place of delivery, as well as any documents required. The Bank then purchases the required commodity from the supplier and the buyer will be obliged to purchase it at the agreed upon price as it is stipulated in the contract. While the Bank sells the commodity, say a car, to the client on a *Murabaha* basis, it registers it in the name of the purchaser and hence pledges it in favour of its own at the Traffic Department, if the pledge is stipulated among the conditions of the contract. In addition, a comprehensive insurance for the car shall be made in favour of the Bank (if this was among the agreed upon conditions of the operation).

- Financing the purchase of lands and real estate on a *Murabaha* basis: Under the *Murabaha* principle, the Bank may also finance its customers to acquire immovable assets, such as land or real estate property. The purchase of such assets is also subject to the same procedures applied to the purchase of cars in terms of the registration requirement. At first, the asset is to be registered in the name of the Bank and then re-registered in the name of the client at the Lands Department of the country when the *Murabaha* operation is completed. According to the Bank's management this type of registration system represented a serious obstacle to the Bank's carrying out large scale financing in this field. The registration procedure implies paying high fees twice, a matter which hinders the Bank from financing the individual's needs of tenements and houses.

- Financing the purchase of articles which can be bought locally but that cannot be pledged: The Bank provides trade finance through funding the purchase of articles which can be bought locally. This includes consumer durables such as furniture, washing machines, refridgerators, gas ovens, bedrooms etc., with the binding on the customer to buy the ordered goods as stated earlier. The Bank also finances consumer non-durable articles (e.g. foodstuffs and clothing and textiles), capital equipment and raw materials, especially in the construction industry, which are required by merchants.

- *Murabaha* financing by means of documentary letters of credit for imports: The Bank also issues letters of credit on behalf of its customers (merchants) to finance imported commodities on the *Murabaha* basis. Letters of credit are arranged for both consumer and capital goods and equipment. In all the above mentioned forms of the *Murabaha* financing the Jordan Islamic Bank usually makes certain of its customer's credit worthiness and also requires deposits to be taken from them as security.

4) The magnitude of the investment techniques in the Jordan Islamic Bank:-

The Bank's management does not disclose very much about the magnitude of types of financing techniques adopted by the Bank (i.e. *Mudaraba*, *Musharaka*, *Murabaha*, etc.). However, there are some statements and tables which are obtained either directly from the Bank or other sources to which the Bank's data was more freely accessible at certain times. These may confirm the fact that *Murabaha* financing clearly dominates the financing operations of the Bank.

Recent data provided by the Bank's management reveals that the contribution of *Murabaha* to total financing investments over the period from 1984 to 1987 was found to be around 80 per cent (See Table 7.6). A percentage of at least 85 per cent, however, may be more accurate. In contrast, the proportion of *Mudaraba* has been very low. In a paper presented in a workshop on "*Investment Strategy in Islamic Banking*" held in Amman in 1987, it was revealed that the *Mudaraba* procedure only accounted for 0.28 per cent of the Jordan Islamic Bank's financing operations in 1984. This is compared with 7.1 per cent for the *Musharaka* financing tehnique (Ahmed, 1986, p.14). At best, if the Management's recent data, shown in Table 7.6, is considered, the *Murabaha* proportion is still very high. Such dominance suggests that short-term trade financing is the more popular line amongst the financing investment of the Jordan Islamic Bank, as will be explained in the next chapter.

Table 7.6 : The methods of finncing investments in the Jordan Islamic Bank, 1984-1987 (JD million & percentage).

Year	*Murabaha*		Others*		Total financing investments	
	JD	%	JD	%	JD	%
1984	51.25	81.33	11.76	19.67	63.01	100
1985	56.13	79.04	14.88	20.96	71.14	100
1986	76.0	79.6	19.46	20.4	95.46	100
1987	86.4	80.0	22.6	20.0	109.0	100

* This includes *Mudaraba, Musharaka* and others.

Source : Provided by the Management of the Jordan Islamic Bank

7.7.5 Specified Investment

This is another type of investment financing which is funded by specified investment deposits as mentioned earlier. In response to the growth of these deposits shown earlier, this type of investment steadily increased from only JD 0.83 million in 1980 to JD 15.89 million in 1988. The substantial growth of 1983, shown in Table 7.5 is closely linked to the already mentioned Housing Project of *al-Rawdha Suburb.* With its modest contribution to this, it reached its high point in 1986 when its ratio to total assets amounted to 8.2 per cent.

7.7.6 Fixed Assets

Fixed assets include the Bank's belongings of land, premises and furniture after depreciation. Over the period under review, the share of fixed assets to total assets declined unsteadily from 3.8 per cent in 1980 to 2.2 per cent in 1988, although they increased in absolute terms (Table 7.5). The increase of their value over the period is mainly attributed to the number of the Jordan Islamic Bank branches and the acquisition of its Head Office premises in Amman.

7.7.7 Other Assets

This item includes the net outstanding balance between branches, cheques for clearing, stationary, paid in advance rents and other items. The total value of these items reached its maximum level in 1982 amounting to JD 2.8 million, then decreased until it reached its minimum level in 1985 amounting to JD 1.3 million. In terms of relative importance, it decreased from 6.6 per cent to 0.9 per cent of total assets in 1981 and 1987 respectively, due to the decrease of some items such as the net outstanding balance between branches and cheques for clearing. Its increase to JD 2.19 million in 1988 only brought its ratio to total assets to 1 per cent (Table 7.5).

7.8 Income and Liquidity

7.8.1 The Sources of Income of the Jordan Islamic Bank

The income of the Jordan Islamic Bank consists of four main elements, namely, revenues from commissions or service charges and fees, income arising from foreign exchange dealings, investment income and other revenues. The magnitude of each of these sources of income over the period 1980 to 1988 is shown in Table 7.7.

Table 7.7 : The sources of income of the Jordan Islamic Bank, 1980-88 (percentages).

Year	Commissions	Foreign exchange Revenues	Investment Revenues	Other Revenues	Total
1980	4.34	27.50	68.16	-	100
1981	11.83	24.27	62.00	1.91	100
1982	8.96	14.13	75.39	1.52	100
1983	11.97	5.39	78.85	3.3	100
1984	10.59	10.31	75.54	3.56	100
1985	8.48	3.46	84.14	3.89	100
1986	7.43	7.49	78.98	6.08	100
1987	6.79	6.56	80.27	6.37	100
1988	8.42	7.16	78.04	5.93	100

Source : Calculated from the JIB's *Annual Reports*, 1980-1988.

Data provided by this table clearly indicates that the investment revenues in the Jordan Islamic Bank are the dominant source of income. Its significant share in total revenues reached its peak in 1985 when it amounted to 84.14 per cent but then declined until it reached 78.04 per cent in 1988. Such dominance provides evidence that the Bank basically relies on investment and financing operations rather than banking services.

As far as the distribution of the Bank's revenues both conceptually and practically is concerned, a brief illumination seems pertinent. Generally speaking, the Bank's income can be treated under three major headings:

i) Total revenues:-

These include the Bank's revenues from banking services, revenues from equity participations and financing activities, which are related to the total funds of both shareholders and depositors in addition to other revenues. According to the Bank's regulations, investment revenues are to be distributed as:

- Miscellaneous provisions - mainly the provision for investment risks which absorb 10 percent of total investment.
- The Bank's portion which constitutes 25 per cent of total investment revenues.
- The depositors' proportion of 65 per cent of total investment revenues.

The Bank's portion of investment revenues plus the other revenues stated above constitute what can be described as "net revenues" or "total income of the Bank".

ii) Net revenues:-

Net revenues or the total income of the Bank may be defined as that part of total revenues left after the deduction of the provisions and the depositors' portion of investment revenues. When total expenses of the Bank are offset by the total income (the net revenues), the excess or the remainder will be the "net profit".

iii) Net profit:-

Net profit in the Jordan Islamic Bank is the difference between the Bank's total income (the net revenues) and its total expenses. The dividends are to be distributed to the shareholders after the deduction of the different types of reserves and the retained profits, as well as any other rewards and remunerations. For an assessment of the performance of the Bank in terms of its profitability, many financial ratios will be prepared in the next chapter.

7.8.2 Liquidity in the Jordan Islamic Bank Versus Commercial Banks

As will be clarified in the next chapter, the maintenance of the balance between liquidity and profitability is a real problem in the management of the bank resources in both conventional and Islamic banks. Thus, the question of liquidity remains a major concern of the Jordan Islamic Bank's management. In this context, it should be noted that there is a major difference between liquidity items of conventional banks and those of Islamic banks. Unlike the former, the latter's balance with other banks earns no money as the Bank does not receive interest. In line with this, Islamic banks also hold no Government securities as they are interest bearing. This uncompetitive position of Islamic banks can be illustrated further through a comparison between the Jordan Islamic Bank and other conventional banks operating in Jordan. Under the regulations of the Central Bank of Jordan, commercial banks deploy their funds as follows:

- 70 per cent of deposits and capital can be extended as credit facilities.
- 9 per cent of deposits must be maintained as cash reserve with the Central Bank.
- 10 per cent of deposits must be invested in Government securities.

From the above it can be concluded that only 11 per cent of a commercial bank's deposits together with 30 per cent of its capital are left to be invested in liquid assets. This is in addition to 19 per cent of the above deployment which are already classified as liquid items.

If the above regulations are to be applied to the Jordan Islamic Bank, bearing in mind its nature as being interest-free, the deployment of its funds can be as follows:

- 70 per cent of deposits and capital for credit facilities.
- 9 per cent of deposits for cash interest with the Central Bank (non-interest earning).

In view of the above, it is clear that in addition to the 9 per cent balance with the Central Bank, there is 21 per cent of the Jordan Islamic Bank's deposits which, by law, is maintained idle, earning no profit.

Compared to the above situation that the commercial banks enjoy,it is clear that the Jordan Islamic Bank is forced to operate at a disadvanteged and uncompetitive position.

Accordingly, to relatively counterbalance the biased situation between the Bank (and any other financial institution operating under the *Shariah* principles) and commercial banks, the Central Bank intitiated some relevant measures as follows:

- The liquidity ratio set for both the Jordan Islamic Bank and commercial banks is 30 per cent of total deposits.
- While the ratio of credit facilities/deposits was set at 70 per cent for commercial banks, it was increased to 75 per cent for the Jordan Islamic Bank.
- The securities holdings (shares of companies) of the Jordan Islamic Bank have been classified as a liquidity item, instead of the bonds and treasury bills holdings of the conventional banks.
- In addition, some of the funds which were given by the Jordan Islamic Bank were excluded from the credit facilities/deposits percentage in correspondence to the exemption of the local consolidated loans of commercial banks.
- The specified investment deposits were also excluded from total deposits in relevant ratios. *Consequently, the equations of both liquidity and credit facilities ratios can simply be defined as follows:*

$$Lr = \frac{C1 + C2 + S}{D},$$

where: Lr = liquidity ratio
C1 = cash at hand
C2 = cash at banks (The Central Bank and others)
S = securities portfolio
D = total deposits

$$CFr = \frac{FI + BL}{D + C},$$

where: CFr = credit facilities ratio

FI = financing investments

BL = bills discounted and interest-free loans

D = total deposits

C = paid up capital

However, from the Islamic bank's viewpoint, the above measures still seem insufficient to achieve unbiased treatment of both Islamic and conventional banks by the Central Bank. In this regard, some relevant measures will be suggested in the last chapter of this thesis.

Chapter VIII

An Evaluation of the Jordan Islamic Bank's Performance

8.1 Introduction

The purpose of this chapter is to evaluate the performance of the Jordan Islamic Bank in the light of the objectives it had set for itself. To this end, the chapter will be divided into eight sections including this introduction. In the second section, a general framework for the assessment will be drawn up. Section 3 will examine the compliance of the Bank's practices to the *Shariah.* The financial performance of the Bank will be evaluated in section 4 in the light of those of all commercial banks in Jordan. Section 5 will examine the market share of the Bank at different levels. While section 6 will test the Bank's role in the economic development of Jordan, the social impact of the Bank's activities will be examined in section 7. The last and the eighth section will focus on the suitability of the Bank's personnel.

8.2 General Framework for the Evaluation of the Bank's Performance

When evaluating a bank or any kind of business, it is usual to consider the objectives set for it. Assessing a bank's performance in the light of its objectives will show the extent to which the bank has been successful in achieving these objectives and in executing the functions which it was designed to perform.

To establish a meaningful and standard framework for the Jordan Islamic Bank's objectives it is necessary to scrutinize these objectives and formulate them into a graphically illustrated framework as shown in Chart 8.1. This framework is adopted from El-Hawwari (1982) with a few modifications.

Under the categorization shown in Chart 8.1, there are six major objectives (which are labelled by El-Hawwari as the key result areas) of any Islamic bank that must be considered as follows:

1. The conformity of the bank's practices with the *Shariah*. This objective represents the constraints that the other objectives of the bank must comply with, namely the laws and the rules of the *Shariah*. The realization of this objective can be seen in several manifestationss as will be explained later.

2. The financial performance of the bank. The sound financial performance of an Islamic bank depends initially on having a variety of financial objectives covering the following:

   - profitability: It is a prime objective for an Islamic bank (as a private business) to maintain satisfactory rates of return for both the bank and its depositors. However, pursuing financial gains must not be the ultimate goal as is unfortunately the case in many Islamic banks.

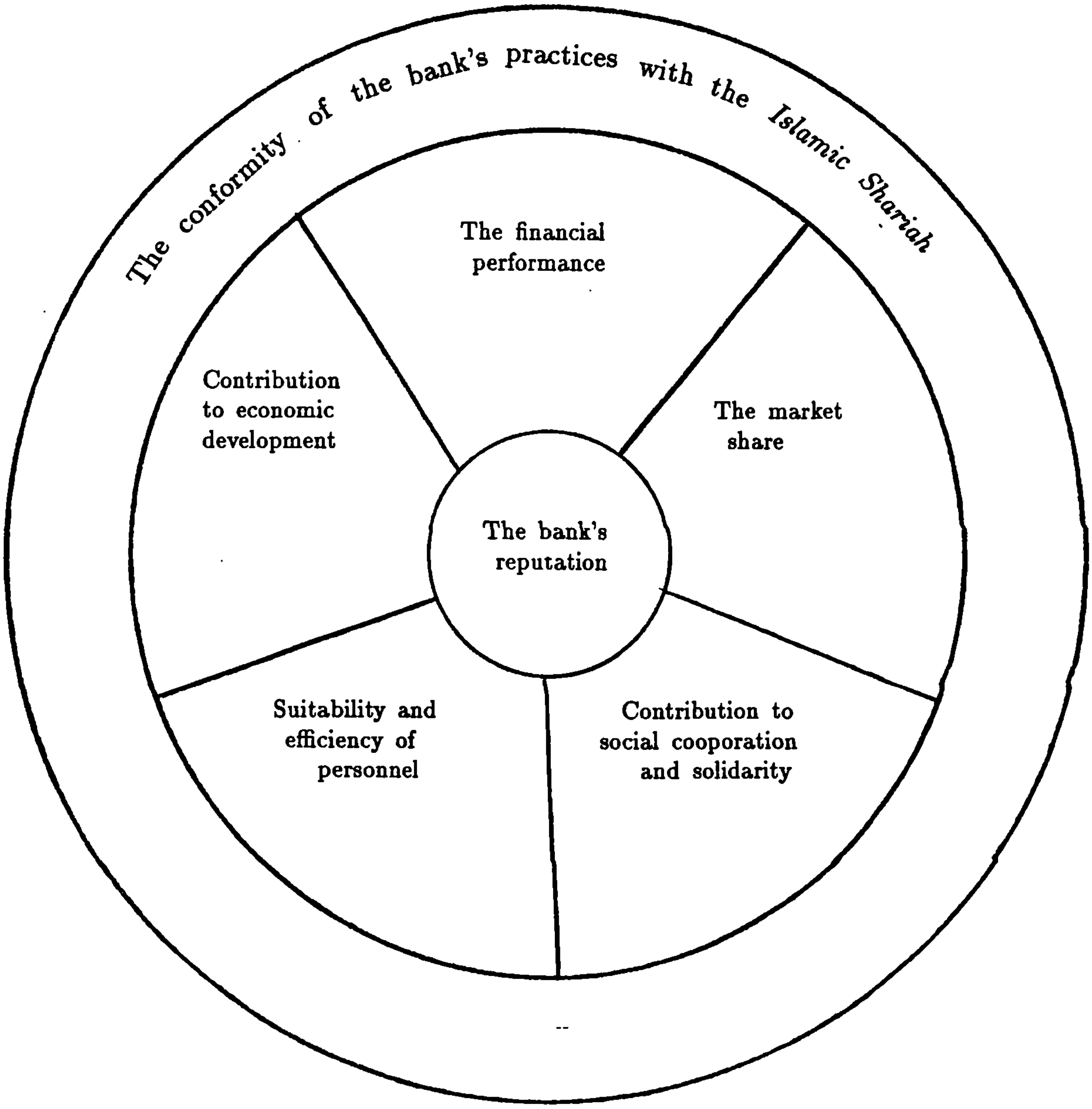
   - liquidity: It is vitally important for an Islamic bank (like any other bank) to maintain sufficient cash and/or liquid funds which can be used to repay depositors. However, the problem of maintaining assets in the form of cash or liquid funds is that the higher the level at which these assets are maintained, the lower is the profitability of the bank as will be further explained.

   - safety: It is common that the management of any financial enterprise usually attempts to minimize the risks involved in their business and/or ensure its safety. However, this must not prevent the management, particularly in Islamic banks, which are assumed to be "risktakers", from taking carefully calculated risks.

   - growth: Achieving a substantial growth of the financial resources of an Islamic bank must be considered as one of the most important aims of its financial management.

3. The market position (share) of the bank. This refers to the share of the bank in both the domestic and international financial markets in relation to the size of its deposits, investments, assets and the base of its clients. This also implies the bank's reputation amongst other financial institutions and banks.

Chart 8.1 : The objectives of an Islamic Bank



Source : Based on El-Hawwari (1982).

4. The contribution to social co-operation and solidarity. The contribution to social justice and prosperity through promoting and strengthening social co-operation and solidarity within Muslim society is set as an important objective for all Islamic banks currently operating. To this end, various activities can be performed as will be explained later.

5. The contribution to economic development. In spite of the previous discussion (in Chapter 4) on the role of Islamic banks in economic development, the latter is still to be considered as an objective of an Islamic bank. There are certain activities through which an Islamic bank may contribute to the economic development of the Muslim country in which the bank is located. Full details in this respect will be provided in section 8.6 of this chapter.

6. The suitability and efficiency of the personnel of the bank. As already emphasised, the quality of the personnel of an Islamic bank is acknowledged as the most problematic issue faced by the present-day Islamic banking movement. The successful performance of an Islamic bank depends heavily on the suitability of its personnel; it is a prerequisite that its management and staff are cognisant of the Islamic principles which regulate a Muslim's life. Several criteria upon which an Islamic bank's position in this respect can be assessed, will be presented in the case of the Jordan Islamic Bank later on in this thesis.

In conclusion, as can be seen from Chart 8.1, the degree of the bank's success or failure in achieving the above objectives will virtually reflect the bank's reputation among other financial institutions in the market in which it exists.

8.3 The Conformity of the Bank's Practices with the *Shariah*

As has already been emphasised, this must be the supreme objective of any Islamic bank. The question of whether the Jordan Islamic Bank's practices are compatible to the *Shariah* or not can be examined by use of the following criteria:
a) The elimination of interest:

The key feature of the Jordan Islamic Bank's transaction is that interest in all forms and circumstances is forbidden. The Bank's activities only comprise the earning of profits and preclude the receipt and payment of interest, discounting, investment in bonds and any dealings on which the interest is misrepresented as profit. Investment deposits are not guaranteed by the Bank* and no returns are offered to depositors in advance as is the case with other Islamic banks (The Islamic Bank International in Denmark IBID, is an example.). Unlike other Islamic banks, the Jordan Islamic Bank earns no profits (interest) on its deposits with conventional banks. (This is emphasised by the Bank's management in their response to the author's investigation.) In this respect, it is worth mentioning that interest received by other Islamic banks on such deposits is said to be used for charity purposes only (see the statements made by Sheikh Abu Ghuddah in the annual reports of the IBID). This, however, may only be agreed upon if this sort of income is separated from the *Halal* income of the bank which is not likely to be guaranteed. b) Non-dealing in prohibited products or activities:

Having questioned many of the Bank's employees and clients it has been confirmed that the Jordan Islamic Bank usually conducts its business strictly in accordance with the *Shariah*. The Bank, thus, does not deal in pork products nor in any enterprise associated with alcohol, gambling or any immoral and un-Islamically oriented activities. According to one of the Bank's employees in the Amman branch,

> "It is very well known in Jordanian society that night clubs and other connected services for instance are no longer part of our investments, as is the case of other *riba*-banks working in Jordan."

c) Adherence to Islamic priorities in investment policies:

One of the principle features of any Islamic enterprise is that it must consider the basic needs of the Muslim society in which it operates when designing its investment policies and plans. For the Jordan Islamic Bank, then, some may argue that it must contribute to providing and satisfying the basic needs of the society through financing productive activities rather than luxury or non-essential consumer goods; it must also participate in the eradication of all undesirable features of the Jordanian economy mentioned earlier. Moreover, they add that

* The proposal made by the former General Manager Dr Sami Homoud in his PhD thesis that Islamic banks may compensate depositors for loss, is no longer adopted by the Jordan Islamic Bank as emphasised by its management.

the Bank must take the lead in ensuring social and economic jsutice. However, in their response to this issue, the Bank's management said:

"Being inhibited by a variety of committments we are trying to do our best."

Nevertheless, it can be argued that the above mentioned objectives can only be served satifactorily within the framework of a pure Islamic economy. It will then be the duty of a rational Islamic authority to formulate the map of Islamic priorities within the real sector of the economy. If such an authority does not exist, how can the boundaries between what is a productive and what is a non-productive activity (from the Islamic point of view) be drawn up? Also, under the supervision of this authority, monetary and credit policy is to be run on the grounds of justice. It follows that facilities are to be extended equally to all financial and banking units in order to enable each of them to contribute effectively to attaining the ultimate goal of the economy: economic development and prosperity. It is not fair, therefore, to judge the performance of an Islamic bank in this regard unless it is seen as part of an entire Islamic economy. It has already been clarified in this study that, the Islamic way of life, being goal-oriented, is inconceivable without an organised community governed in accordance with the tenets of Islam. However, this does not justify a bank's policy, for instance, of importing cosmetic products and pursuing high profits when its country is suffering from a shortage of meat. Apart from the instructions drawn up by the country's economic plan (which is not Islamically oriented), the choice is closely tied to the piety and sincerity of the decision-makers of the bank. It is only the pious people who will sacrifice some of their own personal interests for the sake of public welfare. d) The legitimacy of the financial and banking techniques adopted by the Bank:

In the very nature of Islamic banks, all financial and banking techniques used in the bank's transactions must be based on the *Shariah*. Generally speaking, most of the banking operations performed normally by Islamic banks (in the light of the categorization provided previously in Chapter 4) are practiced in the Jordan Islamic Bank. While operating these methods, the Bank follows procedures demonstrated by contemporary Muslim jurists, so that it does not violate any of the *Shariah* laws by adopting financial instruments that have no root in the *Shariah*. However, several questions have already arisen on the *Murabaha* applications in the Bank. As is mentioned in Chapter 4, there has been quite a controversy in the literature about the legitimacy of the *Murabaha* arrangement from different view points. Having examined the way in which the *Murabaha* is performed in the Jordan Islamic Bank, the three following points are to be stressed in particular:

i) The procedure that the promise involved in the *Murabaha* operation is binding for the client (as explained earlier) is widely criticized by many Muslim scholars who advocate that it lacks a base in the *Shariah.* Relevant to this is the issue of the deposits collected from the client which was also questioned. The core of such a criticism is that the promise committal imposes no risk on the part of the bank, whereas risk is an essential element in differentiating between legitimate and illegitimate transactions in Islam.

ii) According to Article 8 in the *Murabaha* contract of the Bank, if the supplier does not provide the required commodity, only the purchase-orderer is liable for any expenses or commissions already incurred. Such a procedure has no legal or Islamic foundation; it obviously destroys the validity of the Islamic bankers' argument about the liability of Islamic banks for damage or loss occurring before delivering the goods to the buyer.

iii) In line with the above, it appears that the Bank insures the imported commodities against all risks with non-Islamic insurance companies. Although many people reject dealing with these companies in principal, more important perhaps is the implication of such dealing in relation to the *Murabaha* contract. Since the Bank insures commodities with an insurance company, the latter is liable for any damage or loss occuring to the good. However, insurance cost, in fact, is usually added to the cost of the commodity, which the client has to pay. This means that actually the client is the one who pays the insurance cost to the company. This also means that, in reality, the client is the one who is liable for the damage or loss and not the Bank. On the other hand, the *Murabaha* may also have a negative impact on the economy through some undesirable features represented in the social effects of quick profits, risk aversion and luxurious consumption which are against

Islamic values and principles. e) The existence of an effective *Shariah* control authority:

Only a *Shariah* control authority (often represented in a board or committee) can say effectively whether the above mentioned objectives are successfully achieved. The function of the *Shariah* control authority lies in two major spheres (see Briston and El Ashker, 1986):

i) Providing advice to the Board of Directors and the Managing Director on the bank's operations, contracts and procedures to ensure that all are in conformity with the *Shariah.*

ii) Monitoring and checking the actual performance of the bank to ensure that the executive management complies with the principles of the *Shariah* and with the Board's advice which has been given to them.

In view of the above religious duties, the following points are to be made on the *Shariah* Control Authority in the Jordan Islamic Bank:

- As stated earlier, the *Shariah* Control Authority in the Jordan Islamic Bank is limited to a single advisor rather than a board or committee.

- To the misfortune of the Jordan Islamic Bank, it appears from annual reports prepared by the *Shariah* advisor that the duty of the *Shariah* auditing is limited to only the provision of advice rather than checking the actual performance of the Bank. Accordingly, the annual reports prepared by the *Shariah* advisor include no mention of whether he was able to exercise his auditing duties, checking all financial records and all documents.

- Fully aware of the complexity of the control mechanism assumed here, and the speed of having to make investment decisions to seize available opportunities in the financial marktet, it became very clear to the author that the Bank cannot work on a case to case basis with the *Shariah* advisor. The only available solution to the problem, therefore, is at least to have a *Shariah* control board, which may safeguard all moral and legal requirements. For further assurance of the conformity of the Bank's operations with the *Shariah,* this board must be represented in the various departments of the Bank.

8.4 The Financial Performance of the Bank

8.4.1 Some important considerations

In this section, the financial performance of the Jordan Islamic Bank will be assessed by examining the main financial objectives as well as other financial aspects considered important. However, before carrying out this assessment, it is worthwhile considering the following important facts:

- One of the most common characteristics of business in general and of the banking industry in particular, is the conflict between the main financial objectives themselves (profitability, liquidity, safety) on the one hand, and between each of these objectives and *economic development on the other.* In the management of assets/liabilities of an Islamic bank this problem is referred to as the dilemma of four aspects (El-Hawwari, 1982) and can be better termed as "the four-pronged dilemma". Without doubt, it adversely affects the ability of the bank to effectively allocate its funds to the more appropriate uses.

  To explain the mechanisms of this dilemma, an example will be given when the bank will lose potential profits by keeping some of the fund idle. Thus, the bank has to strike a balance between good liquidity and its reducing effects on profits, and high profitability with the consequent worsening of the liquidity position. At the same time, if the bank has long-term investments as a means of promoting economic developments, it will sacrifice achieving short-term or quick profits on the one hand and bring high level of risks on the other. In addition, this may even threaten the adequacy of the bank's liquidity position. Such a situation can be interchangably applied to all factors which constitute the so-called "four-pronged dilemma". Given these considerations, it is to be understood that the task of the energetic and courageous management of an Islamic bank is to arrange their asset structure on the basis of maintaining an optimal balance between profitability, liquidity, safety and the developmental responsibility of the bank.

- The financial data covering the performance of the Jordan Islamic Bank is mainly obtained from its financial statements (annual reports) together with information directly provided to the author by the Management of the Bank. This is in addition to information obtained from other sources dealing especially with the performance of other banks under consideration. It must, however, be stated at the outset that the author is aware of the limitations of using financial statements as a major source of data. Nevertheless, the reliability and usefulness of these statements as the basis for constructing analytical tools cannot be negated (Tamari, 1978).

- Financial ratio analysis is the major instrument used to assess the Bank's current financial position, its past performance and future prospects. Similar to financial statements, financial ratios are also criticized in the literature for having some demerits as a result of which they may not accurately reflect the financial situation of the Bank. However, this does not limit their use as a helpful measurement in assessing the financial position of a business. Ratio analysis achieves three main objectives;

  i) avoiding misleading conclusions in a comparison which might result from comparing absolute tables;

  ii) treating the problem of different sizes in comparison;

  iii) minimizing many of the defects of the financial statements as described earlier (El Ashker, 1987, and Tamari, 1978).

- In the course of this study, it can be noted that only a few traditional financial ratios are applicable for banks in general, and for Islamic banks in particular. However, a set of major financial ratios which certain theoretical and empirical view points may deem necessary have been prepared for the assessment. It should also be noted that the choice of these ratios was based on both the special nature of an Islamic bank and the availability of the required data. In view of the main financial objectives of the bank shown earlier, as well as other aspects, the adopted ratios have been classified into five groups.

- It should be noted that any financial ratio is of little value in isolation. It is necessary to have some predetermined standard with which to compare it. As stated by Parker (1973), the standard can be; (a) a budgeted or an expected one, set by the bank for itself; (b) a historical one based on the performance of the bank; (c) a sectoral one, based on ratios made by other similar banks in the banking sector.

For the Jordan Islamic Bank, budgeted standards are not available. The inclusion of comparative ratios for the period 1980-88 is therefore strongly recommended in this case. As far as sector ratios are concerned, they usually pose a variety of problems for the financial analyst. In the case of the Jordan Islamic Bank, sector ratios prove to be additionally problematic as the Bank is currently the sole Islamic one within the banking system*. In the view of many Muslim economists and financial analysts, the comparison between the performance of an Islamic bank and that of other interest-based ones is generally discouraged. However, keeping this reservation in mind, it would be useful to evaluate the financial performance of the Jordan Islamic Bank in the light of those of the conventional banks in the country since, they compete with the Bank in many spheres. To this end, a comparison between the Bank's records and those of the 17 conventional banks in Jordan will be carried out. To save time and effort within the boundaries of the available data, the comparison will cover the performance of the banks in 1987 only, by using a wide variety of standard ratios. Differences between the compounds of these ratios in the case of conventional banks are taken into account. Each ratio has a denominator and a numerator and can be modified by changing one or both of them to different degrees to satisfy Islamic banks and conventional ones.

- For the Jordan Islamic Bank, ratios which include net profit are calculated both before and after taxation. This is mainly due to the lack of data covering taxation for all banks under consideration. Hence, the comparison between the Jordan Islamic Bank and other banks in terms of these ratios will depend on net profit before tax.

- It must be noted that the common net profit/assets ratio does not adequately reflect the real profitability of an Islamic bank. Although the realized profit of an Islamic bank belongs to both depositors and shareholders, only the latters' share is considered in the above ratio. It is very well known that the

* The short-lived Islamic Investment House was not classified as a bank.

depositors of an Islamic bank participate in the profits or losses of the bank. Thus, this net profit/assets ratio should rightly comprise the depositors and the shareholders' shares. Although in a different sense, this issue was touched upon by Nienhous (1987) when he suggested that considering both the depositors' share in profit and that of the shareholders, the net profit used in the ratio can be labelled as "gross profit". However, this is also not quite accurate. From the accounting point of view, "gross profit" may be understood to refer to profits before deducting expenses (overheads). Nienhous' proposal may, therefore, lead to more misunderstanding. For a real avoidance of misinterpretation, it is suggested that if the depositors and shareholders' shares in profit are to be considered, the net profit used in the ratio must be named the "effective net profit". It must be noted, however, that the effective net profit/assets ratio is only applicable to Islamic banks. In evaluating the overall performance of an Islamic bank, this ratio would fairly reflect its genuine achievements and soundly indicates its advantages if compared to conventional banks. Unlike Islamic banks the main source of the latter's income is the margin resulting from the difference between interest paid on deposits and that charged on loans. Hence, they always try to maximise this margin through minimizing interest paid to depositors and maximizing that received from borrowers. This obvious conflict between the bank's benefits and that of the depositors makes it difficult to use the suggested ratio in conventional banks without problems.

8.4.2 The Financial Ratio Analysis of the JIB Compared to Other Banks

The financial ratio anlysis of the Jordan Islamic Bank over the period of 1980 to 1988 is shown in Table 8.1. It is carried out through five major groups including 31 ratios. This is in addition to the comparitive ratio analysis for all banks in Jordan including the Jordan Islamic Bank shown in Table 8.2.

The plan of this discussion, however, is to follow the five groups category in Table 8.1 and at the same time to refer to the Bank's ranking within the banking system in terms of ratios presented in Table 8.2. Each of the five groups can be highlighted as follows:

Group 1:-

Table 8.1 : The financial ratio analysis of the Jordan Islamic Bank, 1980-1988.

Ratio	1980	1981	1982	1983	1984	1985	1986	1987	1988
Group 1 :									
Growth rate of total assets%	113.00	104.30	43.10	58.00	42.80	24.20	27.50	22.10	12.70
Growth rate of total deposits%	-	117.50	42.00	64.20	41.70	23.50	23.60	25.50	12.60
Growth rate of investments%	-	111.97	86.40	42.20	67.20	12.60	34.30	14.10	13.80
Growth rate of investment revenues%	-	107.90	108.57	22.09	51.48	16.25	19.49	19.41	24.60
Growth rate of net profit%	-	2194	169.00	-31.27	50.45	-25.56	16.25	6.70	40.50
Growth rate of Banks' total revenues%	-	70.13	98.88	3.48	26.21	5.17	20.26	6.32	26.10
Growth rate of total expenses%	-	11.89	59.51	36.43	12.77	24.43	21.76	6.20	20.90
Group 2 :									
Net profit before tax/av. total assets%	0.12	1.36	2.25	1.02	1.03	0.58	0.54	0.46	0.55
Net profit after tax/av. total assets%	0.07	0.85	1.20	0.83	0.91	0.58	0.54	0.39	-
Effective net profit* %	2.68	3.93	4.0	2.83	3.83	3.04	2.97	2.94	3.22
Net profit before tax/av. shareholder's eq.	0.72	12.62	23.52	13.7	19.44	13.49	10.27	8.21	11.30
Net profit after tax/av. shareholder's eq.	0.39	7.88	12.52	11.12	17.22	13.49	10.27	7.02	-
Net profit before tax/no. of shares (JD)	0.01	0.11	0.22	0.15	0.22	0.17	0.13	0.14	0.19
Net profit per share/mkt. price per share%	0.48	7.73	8.65	4.77	6.62	6.35	5.29	7.06	10.43
Rate of return on investment deposits%	8.20	6.80	7.20	5.40	5.70	5.50	5.10	5.00	5.35
Rate of return on fixed deposits%	7.38	6.12	6.48	4.86	5.13	4.93	4.59	4.55	4.81
Rate of return on notice deposits%	5.74	4.67	5.04	3.78	3.99	3.84	3.57	3.45	3.74
Rate of return on saving deposits%	4.10	3.40	3.60	2.70	2.85	2.74	2.55	2.50	2.67
Shareholder's dividends ratio %	-	5.00	8.00	8.00	9.00	9.00	9.00	9.00	12.00
Shareholder's dividends/share market price	-	3.51	3.14	2.54	2.71	3.36	3.66	4.54	6.59

Table 8.1 continued.

Ratio	1980	1981	1982	1983	1984	1985	1986	1987	1988
Group 3 :									
Liquid assets / total deposits %	56.52	53.54	36.05	43.49	33.24	37.82	36.07	41.27	41.47
Liquid assets/current & demand deposits%	185.80	111.10	79.20	124.10	124.90	164.90	173.20	212.20	213.80
Group 4 :									
Shareholder's eq./total assets%	12.97	9.80	9.40	6.20	4.70	4.0	6.20	5.10	4.66
Shareholder's eq./total deposits%	17.20	12.16	11.84	7.44	5.72	4.90	7.81	6.29	5.74
Shareholder's eq./current deposits%	41.37	25.24	26.03	21.22	21.49	21.34	37.49	32.39	29.59
Shareholder's eq./total investments%	29.74	21.71	16.11	11.70	7.61	7.71	10.46	9.28	8.36
Total investments/shr.eq.+inv.deposits%	76.66	87.63	111.62	89.0	96.4	84.37	86.03	79.33	86.99
Group 5 :									
Credit facilities / total deposits %	56.26	56.22	73.93	64.22	75.47	68.89	74.91	68.07	70.07
Investments / shr.eq.+total deposits%	49.71	50.48	66.54	60.24	71.79	65.95	70.23	64.23	65.30
Earning assets / total assets %	49.0	48.0	61.6	57.4	67.5	64.2	67.4	63.2	63.03
Toatl expenses / net profit before tax	127.5	1.28	1.06	2.09	1.60	2.29	2.79	2.78	1.98

* Net profit before tax + depositor's share in profits/average total assets.

Source : Calculated by the author from the Jordan Islamic Bank, *Annual Reports*, 1979-1988.

This group examines the growth of various aspects of the Jordan Islamic Bank over the period of 1980 to 1988. The first ratio indicates the growth rate of the Bank's total assets. As can be seen from the Table 8.1, the highest rate was that of the first two years reflecting the rapid expansion of the Bank's operations. If the Bank's performance in this respect is to be compared with those of other banks in the country, its performance seems quite significantly superior to those of other banks. In 1987, it ranked first above the other banks, and the growth rate of its assets was found to be 22.10 per cent while the average rate for the conventional banks was only 10.24 percent. This means that the Bank's performance was more than twice the average. Such a substantial growth has of course elevated the Bank to one of the four big banks (including the Housing Bank) in the country within less than a decade*. In 1988, however, the ratio fell to 12.70 per cent when the increase of total assets in absolute terms was found to be JD 25.2 million against JD 35.7 million in 1987. The main reason behind such a decline is the distressing business conditions Jordan suffers under the current economic crisis which started in Spring 1988 (see Chapter 6).

The second ratio reflects the growth of the Bank's deposits during the considered period. Apart from the exceptional rate of 1981, the first year in which the Bank started to accept investment deposits, it appears from Table 8.1 that the highest growth rate of the Bank's deposits was that of 1983. Despite the recession which hit the country that year, a substantial growth of 64.2 per cent of the Bank's deposits was achieved when the latter increased from JD 36 million in 1982 to JD 59.1 million in 1983. In 1987, the deposit growth rate was found to be 25.2 per cent. This seemingly reduced rate, however, is still to be appreciated for two reasons:

- It has been calculated in relation to substantial amounts of deposits of 1986 and 1987; hence, the absolute increase in deposits in 1987 was larger than that of 1983, amounting to JD 32.6 million against JD 23.1 million in the respective years.

- The position of the Bank amongst other banks was also venerable as it ranked

* In terms of asset size, the Bank has ranked fourth among other banks since 1986, as will be shown later.

third with a deposit growth of 25.52 per cent, overtaking the three leading banks† as well as many others.

However, under the severe crisis of the Jordanian economy, the growth of the Jordan Islamic Bank was subject to the same decline as the assets experienced in 1988 when the ratio fell to 12.6 per cent.

The third ratio in this group indicates the growth of the Bank's investment including financing investment and the holding of shares. As is shown in Table 8.1, the growth rate of investments is noticably characterized by fluctuations over the considered period. The inconsistency of the investment growth rate with that of the deposits confirms the fact that the former does not depend only upon the flow of deposits, but also upon the availability of the appropriate investment opportunities. While the growth rate of deposists in 1982 was 42.0 per cent, the rate of investment growth amounted to more than twice this figure as it reached 86.4 per cent in the same year. Contrary to this, in 1985, the rate of investment growth amounted to 12.6 per cent as against 23.5 per cent for the deposit growth. Unlike those of assets and deposits, the growth rate of investments in 1988 experienced a very significant decline since they increased in absolute terms as shown in the previous chapter. This indicates the Bank's policy of maintaining a high level of investments in spite of the difficult circumstances under which it operates.

In relation to the above ratio, the fourth ratio in this group reflects the growth of investment revenues before distribution. Unlike interest-based banks which depend on predetermined interest as a main source of income, the incompatability between the growth rate of the Bank's investments and that of the revenues clearly indicates the uncertainty of the income results from investments of an Islamic bank. While the growth rate of the Jordan Islamic Bank's investments amounted to 34.3 per cent in 1986, for example, the growth rate of the revenues from these investments was only 19.45 per cent. In one way or another, such behaviour of investment revenues will naturally have its impact on the growth rate of the Bank's net profit as expressed in the fifth ratio of this group.

† The Arab Bank Ltd, The Housing Bank and the Petra Bank.

Despite the tremendous growth of the Bank's net profit in 1981, which resulted from the inception of investment activities in this year, the rate was found twice to be negative over the examined period. In 1983 and 1985, the growth rate of the net profit was -31.27 per cent and -25.56 per cent as the decrease of the realised profit in absolute terms amounted to JD 270,170 and JD 228,307 in the respective years. This can be interpreted fairly through examining the last two ratios of this group. Of special interest, however, is the substantial growth in net profit achieved in 1988 when the ratio peaked at 40.5 per cent as against only 6.7 per cent in 1987. This means that the Bank seized more profitable investment opportunities although the decline in the value of the Jordanian Dinar cannot be completely ignored.

The sixth and seventh ratios of this group indicate the growth rate of the total revenues of the Bank (defined earlier) and its total expenses respectively. In 1983, the growth rate of total revenues only amounted to 3.48 per cent as against 36.43 per cent for the total expenses. Regardless of the difference in size between the two, such a gap has undoubtedly resulted in the negative growth rate of the net profit as shown above. However, the efficiency of the Bank in handling expense funds is measured in the last ratio of this analysis.

Group 2:-

The second group of ratios indicates the profitability and the overall performance of the Bank. Since the term 'profitability' may reflect different things to different users, a set of indicators have been presented here. These ratios provide an idea of the development of the Bank's profitability over the considered period.

The first ratio of this group is the net profit before tax/average total assets. Regardless of the controversy over defining capital and/or profit, this ratio is to be dealt with as the rate of return on (gross) capital employed in the Bank. In other words, such an indicator is provided by relating net profit before payments of tax to the total funds employed. It measures the capability of the Bank's assets to generate profits.

It appears from the Table 8.1 that the Jordan Islamic Bank had made more profitable use of its resources during the period 1981 to 1984. Since 1985, how-

Table 8.2 : A comparative financial ratio analysis of banks in Jordan, 1987.

Ratios	AB	HB	PB	JIB	CAB	JKB	JNB	BJ	JGB	AJIB	BBME	BCCI	GB	BM	ALB	CB	RB	SJB	Average†
1. %	10.56	10.89	8.79	22.12	20.74	9.95	7.90	-3.86	10.3	3.47	9.33	17.88	-0.05	20.35	19.90	-7.22	2.91	-11.9	10.24
Rank	7	6	11	1	2	9	12	16	8	13	10	5	15	3	4	17	14	18	
2. %	8.36	15.02	13.27	25.52	25.71	10.47	8.81	-2.34	12.03	3.56	9.93	21.38	-0.07	23.21	26.68	-6.77	-1.02	-3.99	11.65
Rank	12	6	7	3	2	9	11	16	8	13	10	5	14	4	1	18	15	17	
3. %	0.46	0.67	0.74	0.46	0.56	1.08	1.34	0.67	0.23	1.19	1.15	1.64	0.07	0.28	0.51	1.85	5.38	0.23	0.72
Rank	13	9	8	13	11	7	4	9	16	5	6	3	18	15	12	2	1	16	
4. %	13.46	11.29	17.41	8.2	8.41	16.15	9.39	7.26	2.82	13.73	14.36	16.38	0.74	2.02	3.59	13.02	16.56	3.63	10.74
Rank	7	9	1	12	11	4	10	13	16	6	5	3	18	17	15	8	2	14	
5. JD	2.66	0.25	0.41	0.14	0.86	0.31	0.26	1.34	0.11	0.27	0.17	0.22	0.01	0.02	0.04	0.16	0.21	-	0.44
Rank	1	8	4	13	3	5	7	2	14	6	11	9	17	16	15	12	10	-	
6. %	2.14	14.97	18.55	7.07	-	18.56	10.2	-	8.87	-	-	-	-	-	-	-	-	-	-
Rank	7	3	2	6	-	1	4	-	5	-	-	-	-	-	-	-	-	-	
7. %	60.76	29.91	47.67	41.27	46.50	42.86	45.17	47.22	38.23	71.95	42.46	69.21	37.33	66.71	43.24	80.94	84.84	-	51.66
Rank	6	17	7	14	9	12	10	8	15	3	13	4	16	5	11	2	1	-	
8. %	305.9	261.4	336.8	212.2	207.4	230.3	162.1	249.9	264.9	3083	526.5	977.6	166.8	1273	188.7	815.3	156.3	-	554.0
Rank	7	9	6	12	13	11	16	10	8	1	5	3	15	2	14	4	17	-	
9. %	3.42	5.76	4.26	5.13	6.12	6.54	13.79	9.46	7.71	8.71	7.81	9.50	10.12	12.69	13.00	15.13	33.26	6.87	9.96
Rank	18	10	17	16	14	13	3	8	11	9	10	7	6	5	4	2	1	12	
10. %	3.93	8.05	4.84	6.30	7.82	7.53	17.81	12.52	9.05	10.36	9.21	11.04	12.14	15.69	16.56	20.34	58.99	12.33	13.58
Rank	18	13	4	16	14	15	3	6	12	10	11	9	8	5	4	2	1	7	
11. %	49.69	75.89	54.82	68.07	74.25	69.26	74.71	79.06	66.85	41.54	71.36	44.91	76.15	54.03	79.75	50.28	81.25	133.82	69.20
Rank	3	13	6	11	11	9	12	15	7	1	10	2	14	5	16	4	17	18	
12. %**	4.00	3.29	2.73	2.78	4.68	1.76	2.41	4.18	12.42	1.14	2.66	0.99	65.8	8.50	7.58	1.11	0.85	8.65	7.53
Rank	11	10	8	9	13	5	6	12	17	4	7	2	18	15	14	3	1	16	

- Data not available.

* This is only for banks listed in the Amman financial market.

** Due to the lack of tax information, the net profit used in this ratio is before tax.

† Average of ratios 5,7 and 8 is for 17 banks.

1. The growth rate of local assets.

2. The growth rate of total deposits.

3. Net profit before tax / average total assets.

4. Net profit before tax / av. total shareholder's equity.

5. Net profit before tax / no. of shares.

6. Net profit per share / market price per share.

7. Liquidity ratio (liquid assets / total deposits).

8. Liquidity ratio (liquid assets / current deposits).

9. Shareholder's equity / total assets

10. Shareholder's equity / total deposits

11. Credit facilities / total deposits

12. Efficiency (total expenses / net profit before tax)

Source : Calculated by the author from annual reports of the banks; see Appendix C. This analysis also has benefited from Aql (1988).

ever, the ratio declined alarmingly until it reached 0.46 per cent in 1987. With such a record in this year, the Jordan Islamic Bank ranked 13th amongst other banks in Jordan. As can be seen from Table 8.2, the average ratio in the banking market in 1987 was found to be 0.72 per cent. In the view of some bankers in Jordan, such a ratio was described as being extremely low. One example can be gleaned from an interview conducted in October 1988 with Mr Alan John Cooper, the General Manager of Grindlays Bank in Jordan, the Bank that achieved the lowest record in 1987 when its ratio stood at 0.07 per cent (Table 8.2). He stated that,

> "the return on capital employed in the Jordanian banking market is too low." (Banks in Jordan, Vol. 7, No. 10, 1988, p. 574.)

However, if the performance of the Jordanian banks is to be compared to other Arab banks in the same year it can still be seen as tolerable.

In a recent survey made by *MEES* (Vol. 13, No. 34, 1988, pp. B1-B3.), it is revealed that the average net profit/assets ratio of 23 leading Arab banks with assets exceeding US$ 2 billion for each was found to be 0.17 per cent in 1987. The two largest Arab banks included in the survey were the BCCI group and the Arab Banking Corporation (ABC) group, both of which declared losses. The ratio of each, hence, stood at -0.02 per cent and -1.01 per cent respectively. Much worse was the achievement of the Gulf International Bank, followed by the Saudi International Bank as their respective ratios were -2.0 per cent and -1.49 per cent.

In addition, if the performance of a specific banking system is to be considered the results of the Saudi commercial banks over the period 1984-1987 can be taken as an example. Of eleven commercial banks operating in Saudi Arabia, eight have reported results for 1987 which also appeared in *MEES* (Vol. 31, No. 31, 1988, pp. B1-B3.). Expressed in terms of net profit/assets their 1987 performance as shown in the Report, at an average ratio of 0.44 per cent is much better than 1986's all time low of 0.33 per cent, although still significantly below 1984's ratio of 1.32 per cent.

Consequently, in the light of the above records, it can be said that the 0.72 per cent average ratio of the Jordan Islamic Bank is far better than those of many Arab banks.

Clearly, the above results of the Arab banks reflect the fact that the last four years have all been difficult and challenging for Arab banks. Pressure on earnings was mounting due to the economic slowdown in the Gulf region and to the erosion of traditional banking activities such as Eurolending, trade and project finance which Arab banks thrived on throughout the seventies and early eighties. As stated by Abouzaki (1987, p. 10):

> "Arab banks have been paying dearly for their 'trigger-happy' lending attitude during the boom. They got punched up right on the face by borrowers who have been either unable or unwilling to repay their loans."

After all, the ratio for the Jordan Islamic Bank has shown tangible improvement in 1988 as it is increased to 0.55 per cent against the 0.46 per cent of 1987 stated earlier.

The second ratio of this group is the same as the first, except for the exclusion of tax payments from the net profit. It gives a clearer picture about the profitability of the Bank which is generally lower than that demonstrated by the first ratio as shown in Table 8.1. Apart from 1980, the lowest ratio is that for 1987 which stood at 0.39 per cent, but the highest was that of 1982 at 1.2 per cent. The 1988 ratio is not calculated due to the unavailability of the tax data.

In the light of the previous argument questioning the suitability of the net profit/assets ratio in Islamic banks, the third ratio of this group indicates the suggested ratio of the effective net profit/average total assets. As is shown in Table 8.1, the ratio is far larger than the above two ratios; its highest point being 4 per cent achieved in 1982.

The fourth ratio indicates the profitability of the Bank in relation to the equity of the shareholders. It should be noted that although this ratio is an indicator of the profit earned on funds invested by shareholders, it does not reflect the actual return drawn by them.

As is shown in Table 8.1, this ratio confirms the above two ratios in indicating a decline in the Bank's profitability over the period 1980 to 1987. While the ratio achieved its peak in 1982 when it amounted to 23.52 per cent, it registered its lowest point in 1987 when it reached 8.21 per cent. In the same year, the Bank ranked 12th among the banks in Jordan. Its record was 2.53 per cent below the average ratio which amounted to 10.74 per cent (Table 8.2). However, in 1988 the ratio rose to 11.3 per cent emphasizing the improvement of the Bank's profitability reflected in the above ratios.

Similar to the second ratio of this group, the fifth ratio is another form of the fourth ratio, but it is computed by excluding the tax payments from the net profit. With the exception of 1985 and 1986, this ratio was obviously lower than the previous ratio (including the tax). The great difference between them was that of 1982, when the fifth ratio was found to be 12.52 per cent against 23.52 per cent for the fourth. The main reason behind such a deviation is the huge amount of tax paid by the Bank in the same year. Having examined this amount in relation to the realized net profit it accounted for 46.8 per cent of the latter in the relevant year.

The sixth ratio of this group indicates the net profit per share of the Bank. As can be seen from Table 8.1, the ratio fluctuated over the considered period, with the highest record of JD 0.22 achieved in both 1982 and 1984. In 1987, the Bank ranked thirteenth amongst the Jordanian banks in terms of net profit per share, when its ratio was JD 0.14 (Table 8.2). Such a result, however, seems to be meaningless, if not misleading, unless the market price per share is considered. This will indicate how much money should be invested in a bank to get specific earnings through one or a number of shares. For illustration, a comparison between the Arab Bank's position and that of the Jordan Islamic Bank in this respect is to be made here. If the market price of the Arab Bank's share which amounted to JD 123.93 by the end of 1987 (derived from CBJ, *MSB*, Vol. 24, No. 2, p. 86) is to be divided by its corresponding amount for the Jordan Islamic Bank which amounted to JD 1.93, the result will be 62.62 shares. This means simply that with the money needed to buy one share of the Arab Bank, one can buy 62.62 shares of the Jordan Islamic Bank. When such a number is multiplied by the net profit per share of the Jordan Islamic Bank of JD 0.14 the result will be JD 8.77. This means that investing a sum of JD 123.98 in the Jordan Islamic Bank will yield the sum of JD 8.77, against only JD 2.14 for the Arab Bank (Table 8.2). However, such an argument can only be appreciated in an Islamic society where investing in profitable enterprises for years is the main concern of investors and not speculating in buying and selling securities.

Relevant to the above, the seventh ratio of this group measures the profitability of each share. It is calculated through dividing net profit per share by the market price per share. As can be seen from Table 8.1, the 1988 ratio is the highest over the reviewed period, as it stood at 10.43 per cent against 7.06 per cent in 1987. With this ratio (of 1987), the Bank ranked sixth among the seven banks listed in the Amman Financial Market, according to Central Bank data. With its lowest ratio of 2.14 per cent, the Arab Bank ranked last (see Table 8.2) confirming the above argument of the comparison between its position and that of the Jordan Islamic Bank.

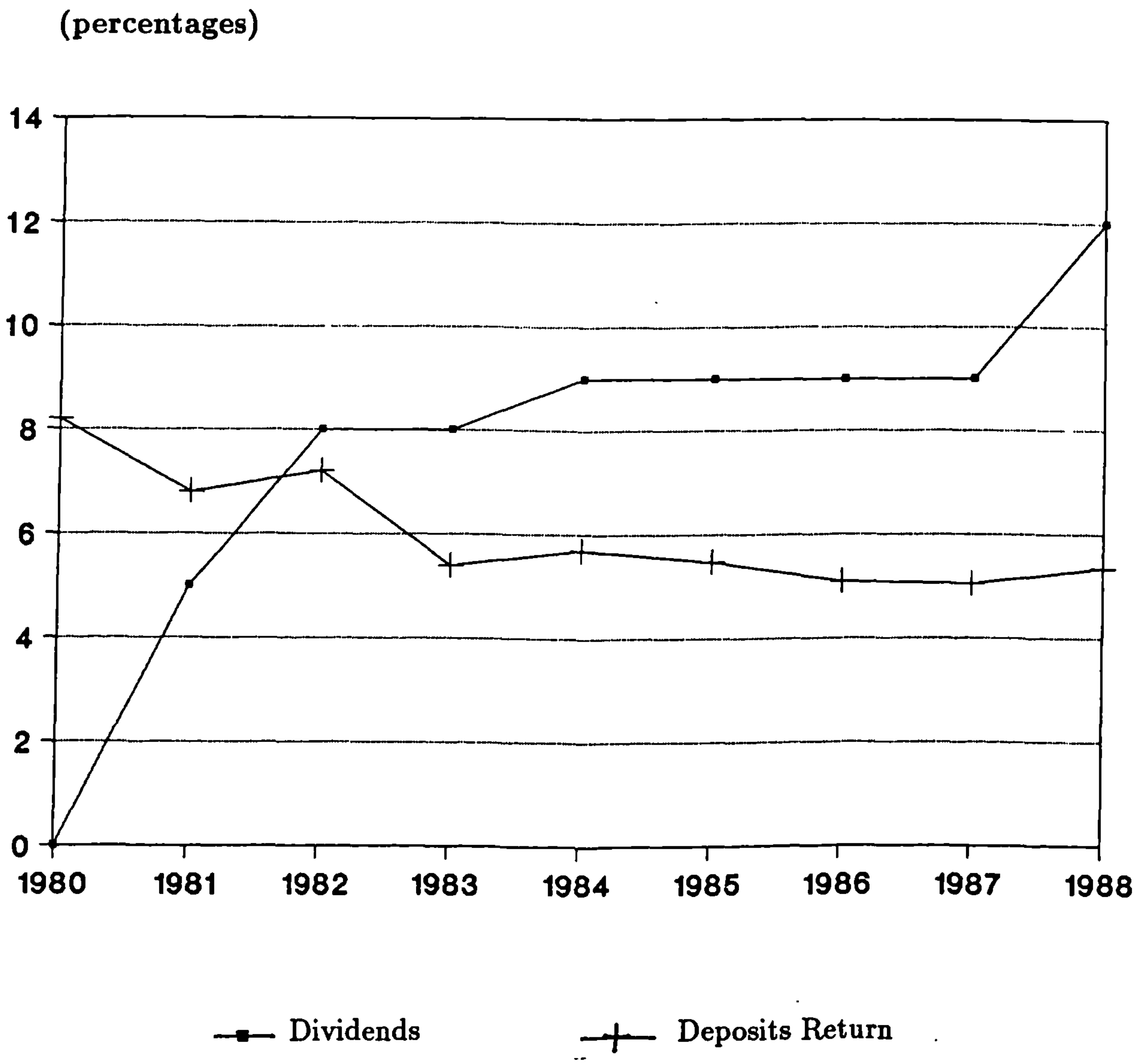
The five following ratios of this group (from ratio number 15 to ratio number 19) are the declared ratios which are usually given in the annual reports of the Bank. However, the focus of this discussion will be the general rate of return on deposits as well as the dividends (see Chart 8.2).

While the general rate on deposits achieved an insignificant increase in 1988, it went down from 8.2 per cent in 1980 to 5.0 per cent in 1987. Before assessing such a decline the following points must be noted:

- In spite of the above downward trend of profitability, the experience of the Jordan Islamic Bank seems to be more reasonable and balanced than those of many Islamic banks. While the rate of return distributed by some of these banks exceeded 20 per cent in the early phases of their operation, many of them are presently suffering from low levels of earnings and some are realizing losses.

- Considering the structure of interest rate on deposits in *riba*-banks shown in Table 8.3, it can be noted that the Jordan Islamic Bank's return was often lower than that paid by the *riba*-banks. However, the Bank has occupied a leading position amongst these banks in terms of deposit growth as mentioned earlier. From among ten depositors interviewed by the author in the Bank's branches in Jordan, seven said that they deposit their money with the Bank only because its Islamic nature meant not being involved in *riba* and any

Chart 8.2 : JIB Shareholder's and Depositors Income.



Source : The Jordan Islamic Bank, *Annual Reports*, 1980-1988.

other activities prohibited by the *Shariah*. Hence, they do not hold any accounts in other *riba*-banks. The other three persons who hold accounts in both the Jordan Islamic Bank and *riba*-banks, considered other factors which accounted for their dealing with the Bank, including earning profits and taking advantage of various services offered by the Bank.

Table 8.3 : The structure of interest rates on commercial bank deposits in Jordan, 1983-1988 (maximum percentage).

	1983	1984	1985	1986	1987	1988*
Demand deposits subject to 2-7 days notice	4.0	4.0	4.0	3.0	3.0	3.0
Time deposits :						
3-6 months notice**	7.0	8.5	8.5	8.5	7.5	7.5
Over 1 years notice	8.0	8.5	8.5	8.5	7.5	7.5
Savings deposits	6.0	6.5	6.5	6.5	5.5	5.5

* Floating since 24-9-1988.

** These may correspond to notice deposits in the Jordan Islamic Bank.

Source : Derived from the CBJ, *Monthly Statistical Bulletin*, Vol. 24 No. 11, 1988.

Nevertheless, the above mentioned decline in return on deposits or its low level in general, in the Jordan Islamic Bank may be explained by the folwowing factors:

- the substantial increase of deposits over the considered period;
- the lack of appropriate investment opportunities within the country;
- the lack of skills necessary for conducting Islamic but business-like projects in the Jordanian market;
- the recommended proportion upon which profits are distributed between depositors and the Bank.

Of the above, both the first and last points are to be highlighted in particular.

Because of the lack of appropriate investment opportunities and skills and under the excessive growth of deposits, the Bank's management may maintain high rates of return only through:

- Discontinuing the acceptance of deposits as was the case in some Islamic banks, mainly in the Gulf area (such as Dubai Islamic Bank and the Kuwait Finance House).
- Allocating their funds to high and immediately-lucrative investments without paying any attention to the needs of the society, as well as any undesirable impact which may affect the economy.

Practically, the management of the Jordan Islamic Bank has adopted neither of the above, according to the General Manager of the Bank in an interview conducted with him by the author in London in March 1989. He stated that the Management has never come across the idea of halting accepting deposits, and once the public look at the Bank as a trustworthy repository one cannot let them down. He added:

> "We are always keen to keep the balance between a reasonable level of profitability and having an appropriate investment policy which may serve the interest of the economy."

Such a statement, however, remains questionable given the Bank's investment policy examined later.

As for the relationship between the return on deposits and the dividends, it seems that the profit's distribution was in favour of depositors only in the first year of the Bank's operations. At the end of the first fifteen months, the general rate of return on deposits was 8.2 per cent against nothing for the shareholdeers. In the meanwhile, the shareholders carried out the burden in order to increase the reserves and the investment provision since only 50 per cent of the authorized capital was paid by the end of 1980, as stated earlier.

However, since 1982, there was a shift in the ratio's trend as it declined for the depositors until it reached the lowest level of 5 per cent in 1987. This is against a remarkabel rise for the dividends as the rate stabilized at 9 per cent over the 1984-1987 period but increased to 12 per cent in 1988.

To understand such a distinction between depositors and shareholders the process of profit's distribution needs to be briefly reviewed. According to the *Mudaraba* arrangement, the Bank may receive its share in profits on two levels. The first is on his efforts when acting as an agent entrepreneur *Mudarib* and the second on his capital jointly invested with the depositor's funds. While the proportion for the first case is decided as 25 per cent of investment revenues against 65 per cent for the depositors as mentioned earlier, it is for the second case tied to the size of its invested funds. But normally this proportion is deducted from that of the depositors which was stated above. Accordingly, in 1987 for example, the actual proportion that the Bank received was 32.4 per cent against 57.6 per cent for the depositors (provided by the Bank's management). When such a proportion including 25 per cent received only on the Bank's effort is expressed in relation to the Bank's capital to indicate the dividend ratio, it would be naturally high, no matter how much the retained profits are. However, reservations can be made on the 25 per cent proportion which may cause the considerable difference between dividends and returns on deposits. Since the funds of both shareholders and depositors are employed in the same uses and face the same level of risks such an imbalanced distribution of profits between both can be criticized as unfair. For further illustration, no guarantee has been enforced within Islamic banks (according to the principles of the *Shariah*) and depositors' funds have no priority when distributing profits, as is the case in conventional banks. Hence, if it is to be argued that the deposits are not as fixed as the shareholder's funds and do not enjoy the same availability as the latter, the answer is that their participation in the realized profits is mainly subject to their maturity, whether they are fixed or not. Moreover, unlike depositors, the shareholders have more possibilities of gain and profitability through trading their shares on the financial marktet.

The last ratio of the profitability's group of ratios is the current yield ratio. This ratio is considered as the most important and the basic measure of return for both preferred and commonstocks (shares) (Scott, 1981). It is computed by dividing annual dividends by the current market price of shares (annual dividends/market price share).

As can be seen from the table, the current yield of the Jordan Islamic Bank over the considered period has fluctuated between 2.54 per cent (achieved in 1983) and 6.59 per cent (achieved in 1988). The dividends over the 1984-1987 period remained constant at 9 per cent. It can be understood that the rise of the yield during this period is due to the decline in the market price of shares. It is a common idea that such a price usually reflect the investor's evaluation and the public's estimate of a bank's present performance and future prospects. Accordingly, there are some important points that need to be clarified in the case of the Jordan Islamic Bank.

1) Similar to all existing stock-exchange in interest-based (un-Islamic) economies, the Amman Financial Market has many drawbacks. It generates practices such as speculation, and consequently fluctuations in share prices which are not related to the economic performance of enterprises. Under such a state of affairs, share prices in the financial market are primarily determined by the speculative practices of money-oriented and gambling-minded businessmen. Such practices are undoubtedly inconsistent with Islamic principles and must be banned within an Islamic economy (see al Sadr, 1981, and al Jarhi, 1985). Clearly, the value that investors place on the Jordan Islamic Bank reflects a speculative gambling estimate rather than an Islamically-oriented public estimate of the Bank's performance. The public's appreciation of the Bank can be noted in the substantial growth of deposits despite its low return as shown earlier and as will be further explained later.

2) According to the Bank's management, the market price of the Bank's shares at one time exceeded JD 4.0 for a share. Such a price, however, was a result of speculations by certain groups who aimed at beating each other in the financial market, without any real benefit being made to the Bank. In line with this, the Amman Financial Market statistics revealed that in 1984 the Jordan Islamic Bank was the most actively traded bank amongst banks and financial institutions listed in the Amman Financial Market in terms of the number of traded shares,

with dealings amounting to JD 2,015,214 in the shares (*Amman Financial Market Statistics* (1978-1987), 1988, p. 40).

3) Despite the above, there are some important immediate factors which may contribute to the decline in the market price of the Jordan Islamic Bank's shares. These factors can be briefly outlined as follows:

a) The recession which affected the Jordanian economy since 1983 resulted in a lack of appropriate investment opportunities for the Jordan Islamic Bank. This also resulted in a low return for the Bank compared with other competing banks.

b) The relatively high risks involved in the Bank's investments if compared to conventional banks listed in the financial market. It is common that investors in financial markets prefer to avoid investing in any shares involved in any types of risk.

c) The rumour which began in 1984 about serious financial difficulties facing the Islamic Investment House, followed by its collapse in late 1986. Such an event may seriously threaten the position of any Islamic bank in the country to the extent that it could possibly result in the bank having to close its doors and to go out of business.

d) The further decline of the market share price of the Jordan Islamic Bank from JD 2.46 in 1986 to JD 1.98 in 1987 may also be attributed to the big bang or the collapse of the international financial market in 1987 which was referred to earlier. Most of the local financial markets including the Amman Financial Market were naturally affected by this crash.

4) As a result of what is stated in (a) and (d) of the above mentioned points, the fall in share prices of banks in Jordan was not restricted to the Jordan Islamic Bank. The prices of most banks and financial institutions listed in the Amman Financial Market have experienced a notable decline over the last five years. Examples of this can be found in the case of both the Cairo Amman Bank and the Petra Bank. While the market price of the latter's shares had fallen from JD 7.25 per share in 1983 to JD 2.40 per share in 1987, the former's share price had

fallen from JD 40 to JD 25 in the respective years (*Amman Financial Market, op cit*, p.56).

Group 3:-

The third group of ratios indicates the liquidity position of the Jordan Islamic Bank. The first ratio of this group measures the liquid assets as defined in the previous chapter divided by total deposits.

As can be seen from the Table 8.1, the liquidity ratio of the Jordan Islamic Bank has always exceeded the liquidity requirements decided by the Central Bank. Apart from the first two years, the lowest ratio was that of 1984 which stood at 33.2 per cent and the highest was in 1983 which amounted to 43.5 per cent. In 1988, the ratio was found to be 41.47 per cent which means that the Bank has excess liquidity of 11.47 per cent. This high ratio reflects the recession in the Jordanian economy and the lack of appropriate investment opportunities in the present climate as mentioned earlier. Given this situation, excess liquidity is the dominant feature of the Jordanian banking system in view of the attempt to avoid high risk advances, considering this excess of cash or liquidity as a welcome hedge during the period of business uncertainty.

Hence the excess liquidity in the Jordan Islamic Bank is still lower than those of the majority of *riba*-banks in Jordan. In 1987, it ranked fourteen amongst those banks as its excess liquidity amounted to 11.27 per cent against 22.72 per cent as average ratio for all banks (Calculated from Table 8.2).

The highest liquidity ratio in the same year were those of both al Rafidin Bank and the City Bank, as their actual liquidity ratio amounted to 84.84 per cent and 80.94 per cent respectively (Table 8.2).

A general impression of liquidity can also be obtained by seeing how far current or liquid assets go towards repaying the current liabilities. When expressed as a ratio this is known as quick ratio (Cox, 1988) and is calculated by dividing liquid assets by current deposits. This ratio is the second ratio of this group; the standard value of which must be 100 per cent to meet sudden calls of current deposits. For the Jordan Islamic Bank, it was only in 1982 that the ratio was lower than such a standard as it amounted to 79.23 per cent. Its highest point, however, was in 1988 when it stood at 213.84 per cent compared with 212.20 per cent in 1987. These are seemingly high ratios, yet, they are much lower than those of many *riba*-banks.

As it can be seen from Table 8.2, the Jordan Islamic Bank in 1987 ranked twelveth amongst all banks in terms of the quick liquidity ratio. For the interpretation of the extremely high ratios of the first five banks shown in the table, it can be said that the main cause of such a tendency is the insignificance of their current deposits in relation to total deposits. For the Arab Investment Bank which ranked first with its ratio of 3083.4 per cent, for instance, the current deposits only accounted for 2.33 per cent of total deposits.

The general conclusion of the liquidity analysis of banks in Jordan in 1987 is that from amongst 17 banks covered in the table (the eighteenth's data is unavailable), there are thirteen banks which keep more than JD 2 for each JD of current account deposits. In the Arab Investment Bank, this amount reached JD 30.83 and for the Jordan Islamic Bank it was JD 2.12.

On the whole, by means of the above two indicators, the liquidity position of the Jordan Islamic Bank can be considered as relatively high. In their explanation of such a position, the management of the Bank say that retaining such a degree of liquidity is an important factor to remain viable or to survive in a hostile business climate such as that of Jordan. Nevertheless, from an Islamic point of view, the liquidity ratio should be kept to the lowest possible required by the law, as the Bank needs to invest more in order to earn a reasonable rate of profit and, thus, benefit both the shareholders and depositors.

Group 4:-

The fourth group of ratios examines to what extent the structure of the Bank's assets/liabilities satisfy the safety factor as a financial objective. It indicates the bounds of risks within which the Bank operates.

The first ratio in this group measures the adequacy of capital, expressed in the shareholders' funds, in relation to the total assets. Bearing in mind what was stated about the Islamic bank's capital adequacy in the previous chapter, it seems that the capital base of the Jordan Islamic Bank over the considered period is quite reasonable. By the end of 1987, the Bank's relevant ratio stood at 5.1 per cent. Despite the reservations which may be made about comparing the adequacy of an Islamic bank's capital with that of a *riba*-bank, the Jordan Islamic Bank with the above ratio ranked fifteenth amongst other banks in Jordan. While the Jordan Islamic Bank occupied such a position only 9 banks from amongst 18 operating in Jordan have met the capital requirements of the Basle Committee's standard of 8 per cent for the Arab commercial banks (*Arab Banker*, Vol. 8, No. 5, September/October 1988). Other banks, including the leading Arab bank which ranked first from the bottom with its 3.24 per cent ratio, fall short of the target (Table 8.2).

The second ratio of this group indicates the solvency of the Bank as it measures the shareholder's equity in relation to total deposits. It is worth mentioning that this ratio is mainly designed for *riba*-banks in order to measure the bank's capability to repay deposits. It is not convenient, therefore, to use such a ratio to judge the performance of an Islamic Bank since both shareholders and depositors are liable to the same risks.

However, the ratio is calculated here to give an idea about the general trend in the Jordanian banking system, including the Jordan Islamic Bank. With its 6.29 per cent ratio in 1987, the latter ranked sixteenth amongst banks in Jordan (Table 8.2).

More appropriate for Islamic banks is the shareholders/current deposits ratio. From Table 8.1, it can be seen that the Jordan Islamic Bank enjoyed a reasonable capability to repay trust deposits (demand and current) over the considered period. Apart from 1980, the highest ratio was that of 1986 which stood at 37.49 per cent as a result of the increase of the Bank's capital that took place that year.

The fourth ratio of this group is the shareholders' equity/total financing investments ratio, which indicates the safety margins in the Bank's investments. It measures the ability of the shareholders' funds to cover risks of investments. Over the considere period, the Bank's ratio fluctuated between 29.74 per cent (in 1980) and 7.41 per cent (in 1985). This low ratio in 1985 partially led to the increase in the Bank's capital in 1986 which resulted in the rise of this ratio to 10.46 per cent in the same year. This extremely low ratio in general mirrors the peculiar nature of Islamic banks as being risk-takers. In contrast to this is the *riba*-bank's position, as when the safety margin was calculated for one of the *riba*-banks as an example the result was unimaginable. By using investments in shares for the ratio for the Bank of Credit and Commerce in 1987 this ratio was found to be 4231.25 per cent (calculated from the BCC's balance sheet).

In line with the above ratio, the fifth and the final ratio of this group reflects the investments risks from different angles. It indicates the total financing investments in relation to the shareholders' equity plus the investment deposits. Clearly, this ratio as presented in Table 8.1 confirms the above ratio in reflecting a high level of risks involved in the Jordan Islamic Bank's investment over the considered period. Of special interest is the ratio of 1982, which exceeded 100 per cent as it stood at 111.62 per cent. The confusion which may result here is that such a table means that the Bank's investment exceeded the available funds for investments. The only interpretation of such a position is that some of the current and demand deposits were invested, in addition to the shareholders' funds and the investment deposits. This can easily be confirmed through a quick look at the liquid assets/current deposits ratio, which was mentioned earlier and presented in group three of the ratios. It can be seen from the relevant table that 1982 was the only year in which this liquidity ratio was less than 100 per cent as it stood at 79.23 per cent.

Group 5:-

This group of ratios indicates to what extent the Bank was successful in utilizing the available funds for investments. The first ratio measures the ability of the Bank to allocate the available deposits which increased from 56.3 per cent in 1980 to 70.07 per cent in 1988. It must be noted that this ratio is originally designed to examine a *riba*-bank's credit advances in relation to total deposits. However, the Jordan Islamic Bank is also subject to this ratio according to the Central Bank regulations but under specified conditions concerning the Bank in particular as mentioned in the previous chapter. In 1987, the Bank ranked eight among other banks in Jordan as its ratio amounted to 68 per cent against an average ratio of 65.3 per cent for all banks. It is important to note that the classification of banks in terms of this ratio is carried out from the security viewpoint; the lower the ratio, the higher the rank.

The second ratio measures the ability of the Bank to allocate its available fiancial resources for investments. It includes, in addition to deposits, the shareholders' equity. This ratio confirms the results which could be derived from the first one, indicating that the efficiency of the Bank improved since 1982, although the ratio fluctuated.

The third ratio examines the earning assets to total assets, where the earning assets includes securities portfolios and financing investments. This ratio indicates how successful the Bank's management is in putting assets to work in an earning and profitable structure. Table 8.1 shows that this ratio increased steadily from 48.0 per cent in 1981 to 63.03 per cent in 1987 which means that the Bank's performance during the period has generally improved.

The last indicator measures the general and administrative expenses in relation to the net profit of the Bank. It shows the efficiency of the management in allocating their funds to cover these expenses. In 1987, the Bank ranked nineth amongst other banks, when the indicator of its efficiency amounted to 2.78. In 1988, however, the Bank's performance improved when the indicator fell to 1.98 (see Tables 8.1 and 8.2).

8.5 The market share of the Jordan Islamic Bank

The market share or position of the Jordan Islamic Bank may be examined on three levels: the local market, the Islamic banking market (ie within the Islamic banking movement) and, finally, the international market. Each of these levels can be highlighted as follows.

8.5.1 The JIB's Position in the Local Market

It has already been shown that the Jordan Islamic Bank has experienced a rapid expansion of its operations since its establishment. Also, the financial ratio analysis, conducted earlier, showed the ranking of the Jordan Islamic Bank against other banks in Jordan in terms of various criteria. However, there are certain points which need to be stressed.

- The Bank's branch network: Over the period 1980 to 1988, the Jordan Islamic Bank has successfully established itself among the leaders in the investment and banking market. It was reported that, by the end of 1988, the Bank had fifteen branches, stretching from Irbid in the north to Aqaba in the south. This is in addition to another three branches still under establishment, as reported by the manager of the Bank. In this respect, the Bank's capacity was the same as that of the Arab Bank, which opened 15 branches over the same period (The Association of Banks in Jordan, *Annual Report*, 1987, p. 20). Such an expansion has naturally helped the growth and prosperity of the Bank, despite the setbacks which have marked the Jordanian economy over the last decade.

- The Bank's clients: From only 15,000 in 1981 the number of the Bank's clients mounted to about 110,000 in 1987 and 140,000 in 1988 (*Annual Reports*). Although there are no details about the type of those clients (whether they are small or large savers and businessmen), such progress, in a small country like Jordan, is truly significant. Since the Central Bank provides no information about the number of the clients who deal with the banking system as a whole, it is difficult to exactly identify the Bank's share within the banking system. However, having investigated this issue with some of the Central Bank's officials it is said that the size of the banking system's clients can be estimated to be the same as that of most of the LDC's, at about 20 per cent of the total population. Jordan's population was estimated at 2.9 million in 1987 (see Chapter 5), so the number would be about 0.6 million. Accordingly, if the above number of the Jordan Islamic Bank's clients is compared to the total, the Bank's share within the banking system would be around 19 per cent. It must be noted that since the number of the banks operating in Jordan is 18, the average bank's share is 5.6 per cent (i.e. 1/18). This means that the contribution of the Jordan Islamic Bank is fairly high.

- The size of the Bank's assets: As mentioned earlier, the Jordan Islamic Bank has become the fourth largest bank in the country in less than a decade. In 1987, the total assets of the Bank (JD 197.42 million) accounted for 6.88 per cent of the total assets of the 18 banks in Jordan (see Table 8.4). Furthermore, if the Housing Bank, as a specialized credit institution both publicly and privately owned, was excluded, the Jordan Islamic Bank would be the third largest bank in Jordan.

- The size of the Bank's deposits: The tremendous growth of deposits has been one of the most prominent features of the Jordan Islamic Bank over the last decade, as shown earlier. Similar to its assets' share mentioned above, the total deposits of the Jordan Islamic Bank in 1987 (JD 160.57 million) accounted for 6.86 per cent of total bank deposits. With such a contribution the Bank ranked fourth among the Jordanian banks, surpassing many of the leading banks, as shown in Table 8.3 earlier. However, if the amount of the specified investment deposits were to be added then the Bank's share of the total bank deposits would be 7.5 per cent. Recent data provided by the Bank's management indicates that the Bank's share in bank deposits in Jordan amounted to 7.71 per cent in 1988 (excluding the specified investment deposits). The Bank's share in bank deposits in the private sector is higher than this amounting to 8.1 per cent (ie 2.3 per cent above the average (5.9 per cent)) in the same year. In areas where the Bank has branches, its share of bank deposits is remarkably high, amounting to 11.7 per cent.

- The size of the Bank's shareholders' equity: As can be seen from Table 8.4, in 1987 the Jordan Islamic Bank ranked seventh amongst other banks in terms of the size of its shareholders' equity when it amounted to JD 10.12 million. This demonstrates the fact that the Bank depends heavily on deposits as a major source of its funds, rather than shareholders' equity.

- The Bank's share in the bank credit facilities in Jordan: Although interest-free advances extended by the Jordan Islamic Bank are totally different from those extended by conventional banks, which charge interest, it is useful to examine the Bank's share in this field. However, the available data only covers the Bank's record in 1988. While the Bank's general share in bank advances in Jordan amounted to 7.6 per cent in the relevant year, its contribution in areas where it has branches amounted to 13.5 per cent. Since the average share, as shown earlier, is 5.6 per cent, the Bank's 7.6 per cent is quite high.

Table 8.4 : The market share of banks in Jordan, 1987 (JD million & percentages).

Bank	Assets			Deposits			Shareholder's equity		
	JD	Market share%	Rank	JD	Market share%	Rank	JD	Market share%	Rank
Arab Bank Ltd. (ABL)	735.85	25.65	1	640.90	27.36	1	25.19	13.54	2
Housing Bank (HB)	473.57	16.50	2	338.34	14.45	2	27.26	14.65	1
Petra Bank (PB)	290.56	10.13	3	206.14	10.94	3	12.39	6.66	4
Jordan Islamic Bank (JIB)	197.42	6.88	4	160.57	6.86	4	10.12	5.44	7
Cairo-Amman Bank (CAB)	168.48	5.87	5	131.84	5.86	5	10.31	5.54	6
Jordan-Kuwait Bank (JKB)	150.63	5.25	6	129.11	5.63	6	9.72	5.22	9
Jordan National Bank (JNB)	144.64	5.04	7	112.00	5.51	7	19.95	10.72	3
Bank of Jordan (BJ)	121.66	4.24	8	91.96	3.93	10	11.51	6.18	5
Jordan and Gulf Bank (JGB)	120.46	4.20	9	102.57	4.38	8	9.29	5.00	10
Arab Jordan Investment Bank (AJIB)	112.53	3.92	10	94.59	4.04	9	9.8	5.27	8
The British Bank of the Middle East(BBME)	78.41	2.73	11	66.42	2.84	11	6.12	3.29	13
Bank of Credit and Commercial Int. (BCCI)	71.24	2.48	12	61.32	2.62	12	6.77	3.64	11
Grindlays Bank (GB)	53.06	1.85	13	44.19	1.89	13	5.37	2.89	16
Bank al-Mashrek (BM)	42.88	1.49	14	34.69	1.48	14	5.44	2.92	15
Arab Land Bank (ALB)	42.07	1.47	15	33.01	1.41	15	5.47	2.94	14
Citi Bank (CB)	40.97	1.43	16	30.48	1.30	16	6.20	3.33	12
Rafidan Bank (RB)	12.99	0.45	17	7.32	0.31	17	4.32	2.32	17
Sarian-Jordan Bank (SJB)	11.93	0.42	18	6.70	0.29	18	0.82	0.44	18
Total	2869.35*	100	-	2342.15	100	-	186.05	100	-

* This total asset figure differs from that in Table 6.5a since the latter is a preliminary record.

Source : *Annual Reports* of the banks, 1987 (Author's calculations).

8.5.2 The JIB's Position in the Islamic Banking Market

At the outset, it must be stressed that the Islamic banking market includes those individual Islamic banks and financial institutions which currently operate in different countries, under different circumstances or conditions. This means that the comparison between the market position of these banks cannot be objectively carried out without problems or reservations. However, a comparison between the Jordan Islamic Bank and other Islamic banks can be carried out in terms of the size of their assets, in order to find out the Bank's share of the base capital of the Islamic banking movement. Hence, in a list of the top 15 Islamic banks working in the world in 1987, prepared and published by the *Banker* (December 1988), the Jordan Islamic Bank ranked third, with total assets amounting to US$ 559 million. The Bank which headed the list was the Kuwait Finance House with total assets of US$ 3.92 billion. It was followed by the Faisal Islamic Bank of Egypt, whose assets were found to be US$ 1.9 billion.

Taking into consideration the fact that Jordan neither enjoys a competitive position in terms of the availability of financial resources (the base of fund) compared with Kuwait, nor can it compete with Egypt in terms of population (the base of clients), the position of the Jordan Islamic Bank is quite significant. In other words, this position of the Jordan Islamic Bank must be all the more highly regarded since it operates in a country which is poor in both financial and human resources.

8.5.3 The JIB's Position in the International Banking Market

The task of tracing the share of the Jordan Islamic Bank in the international banking market is quite difficult. However, it is possible to turn to a list of the 100 largest Arab banks (in terms of assets) published by the *Banker* (December 1988).

It is worth noting that such a list is restricted to Arab banks, including many which are considered leading banks by international standards. Thus, it is perhaps more accurate to look at this as representing a regional record rather than an international one. However, it is still, in fact, useful to give one an insight into the matter. For 1987, the list included only two Islamic banks, the

Kuwait Finance House, which ranked 28th with total assets of US$ 3.92 billion, and the Faisal Islamic Bank of Egypt which ranked 48th with total assets of about US$ 2 billion. What seems strange about this list is that it included some Jordanian banks which are smaller than the Jordan Islamic Bank (in terms of assets), whereas the latter is excluded. With its total assets of US$ 599 million (according to the Banker), however, the Jordan Islamic Bank is qualified to be listed in 85th place in the list. It comes just below the Egyptian American Bank which ranked 84th with total assets of US$ 606 million, and before the Kuwait International Investment Company which ranked 86th, with total assets of US$ 578 million (i.e, less than the JIB's assets).

In the light of the above review, it can be said that in spite of the infancy of the Jordan Islamic Bank, it has been highly successful as demonstrated by its market share. Such a competitive market position for the Jordan Islamic Bank may reflect a common positive public response, which enabled the Bank to build up such a strong capital and client base. There are many reasons which may account for such a public attitude which will be pinpointed in the conclusion of this thesis.

8.6 The Role of the JIB in the Economic Development of Jordan

Muslim scholars and economists do not often separate social dimensions from economic development, refering to a comprehensive process, namely socio-economic development. However, it seems more convenient for the analysis to treat them separately, as suggested in the general framework shown in Section 2 of this chapter.

The role of the economic development of the Jordan Islamic Bank must be assessed in the light of the previous discussions made in Chapter 4, when addressing the issue for Islamic banks in general. The evaluation can be carried out by examining the Bank's contribution to the following areas.

8.6.1 Raising Funds for Investment

This indicates the Bank's ability to raise funds and to contribute to the institutionalization of savings, through its paid up capital and deposits. It is through a range of saving media that small amounts of personal savings are collected and pooled to provide the finance for investment projects.

Apart from its paid up capital, the Jordan Islamic Bank, with its nationwide network of branches, has suceeded in offering various savings and investment facilities (see Chapter 7) to its customers. In this, it has many competitors. It has already been shown that the Bank faces competition from a whole range of banks and financial institutions, offering numerous schemes with a tempting array of different interest rates and conditions. However, the Bank's share in the bank deposits of the country, as mentioned earlier, indicates that the Bank's role in mobilizing savings and attracting deposits is even more successful than its management has anticipated. Despite the difficult market conditions currently prevailing in Jordan, the Bank's executives are very pleased with their 7.7 per cent market share of deposits in 1988, as mentioned earlier.

8.6.2 Raising Funds in Foreign Currencies

The innovative decision taken by the Bank's management in 1983 to accept investment deposits in foreign currencies enables the Bank to have a hand in mobilizing this vital source of funds for economic development. Within five years, the Bank's investment deposits in foreign currencies have multiplied about five times, increasing from only JD 1.27 million in 1983 to JD 6.12 million in 1987 (the Bank's *Annual Report*, 1987). With this record, the Jordan Islamic Bank has, in 1987, overtaken the Jordan National Bank, as its corresponding deposits in foreign currencies amounted to only JD 1.81 million in the same year (JNB, the *Annual Report* 1987). In 1988, moreover, the Bank's investment deposits in foreign currencies rose to JD 8.56 million. This is in addition to JD 0.57 million of trust account deposits in foreign currencies, which are ignored here as they are non-investment deposits (The Bank's *Annual Report*, 1988).

8.6.3 Financing Various Economic Sectors of the Country

To begin with, it is important to realise that the investments of the Jordan Islamic Bank are mostly allocated to the local market, as emphasised by its management. According to them, only around 10 per cent of the Bank's investments are conducted abroad. It is common that the allocation of the employed funds of a bank are usually examined through investigating the sectoral distribution of its financing operations and their significance. The sectoral distribution of funds extended by the Jordan Islamic Bank, compared with those of commercial banks, in the period 1984-1988, is shown in Table 8.5. However, the Bank's performance in 1987 and 1988 is illustrated by Chart 8.3.

Table 8.5 : JIB and Commercial Banks (CB): A comparative sectoral distribution of finance, 1984-1988 (percentage).

	1984		1985		1986		1987		1988	
Sector	JIB	CB	JIB	CB	JIB	CB	JIB	CB	JIB	CB
Agriculture	0.53	2.20	0.59	2.10	0.51	2.40	0.52	2.70	0.50	2.88
Industry	26.60	14.30	28.6	14.8	34.90	15.80	32.90	14.60	26.00	13.55
Transport	13.70	4.90	9.40	5.00	9.90	3.50	5.20	2.60	4.70	3.18
Trade	21.90	25.00	23.80	24.20	22.90	24.30	23.60	24.00	28.00	24.36
Prof.& private indiv.	7.20	10.20	8.20	10.00	7.50	9.80	11.60	10.50	15.90	12.43
Services & others	12.77	15.50	11.21	15.90	7.09	18.90	9.89	21.90	11.50	20.59

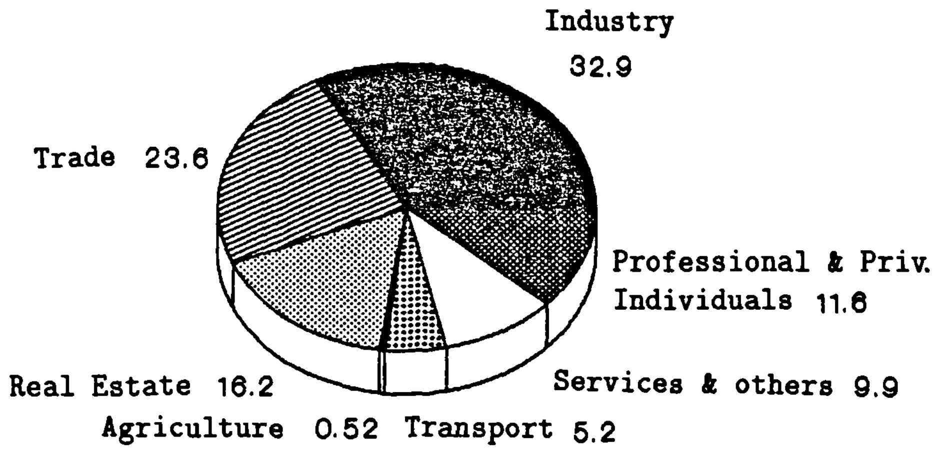
Source : Data for the CB's calculated from: Central Bank of Jordan, *Monthly Statistical Bulletin*, Vol.24, No.1, January 1988. Data for the JIB is provided by the management of the Bank.

From 1984 to 1987, the major share of the Bank's financing and investments was allocated to the industrial sector. In 1987, this share accounted for 33 per cent of the total financing made by the Bank. Such a contribution had significantly surpassed that of commercial banks, as their share only accounted for 14.6 per cent of their total advances in the same year. In 1988, however, finance made by the Jordan Islamic Bank to the industrial sector fell notably to 26 per cent of the Bank's total advances, bringing the sector second, after trade and commerce. Similar to all commercial banks in Jordan, finance extended to the industrial sector by the Jordan Islamic Bank is basically short-term finance. Although manufacturers had been supplied with their requirements of equipment and raw materials, the majority of financing operations were implemented according to *Murabaha* techniques, as shown in the previous chapter. In addition, the effects

Chart 8.3 : JIB Investments: Sectoral Distribution.

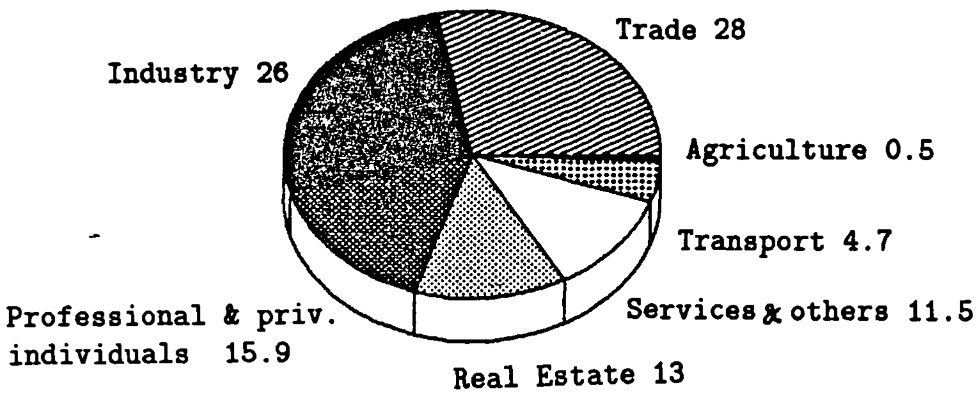
(percentage).

Total Investments = JD 109.3 million



1987

Total Investments = JD 126.6 million



1988

Source : The Jordan Islamic Bank, *Annual Reports*, 1987,1988.

of the Bank's activities can hardly be seen in the industrial base of the Jordanian economy. While the trade sector, on the other hand, was classified as the second priority for the Bank's financing operations until 1987, it became first in 1988, as stated above. It absorbs a substantial fraction of the Bank's funds, found to be 23.6 per cent in 1987, as compared to 28 per cent in 1988. Only in this year (1988) did the Bank's advances to this sector exceed those of commercial banks, which are historically classified as over-exposed to trade (see Table 8.5).

Advances for real estate and construction were third in importance until 1987, as Table 8.5 shows, accounting for 16.2 per cent of the Bank's deployment in 1987. However in 1988 a drop in the share of this sector took place when it assimilated only 13.4 per cent of the total funds extended by the Bank. The major event of the Bank's achievements in this field was the accomplishment of the *al Rawdha suburb's* housing project, mentioned earlier, composed of 242 housing units and many facilities and services, including a market, mosque and library. However, much criticism of this project was heard from the public, since the architectural design of its housing units was not adopted to meet the needs of the low and limited income groups, who either cannot afford the existing prices or can only pay for them at the expense of other necessities. Nevertheless, by the end of 1988, the houses of the suburb were all sold (the Bank's *Annual Report*, 1988), while the last of the 67 stores of the suburb's market had been hired by the middle of 1989 (provided by the Bank's management).

The share of professional and private individuals in the Bank's financing operations has shown improvement over the reviewed period, as it accounted for 11.6 per cent of total financing in 1987, compared with 7.2 per cent in 1984. A further substantial increase took place in 1988 when the ratio rose to 15.9 per cent. The important fact to emerge here is the Bank's policy in allocating advances to this sector. Although the Bank made some advances to professionals such as doctors and dentists, no major efforts were made towards financing and developing small manufacturers or those artisans who often operate and live in a hand-to-mouth financial existence. In spite of the increasing number of clients who benefited from advances made to this sector, amounting to about 10,000 in 1988, around 4,500 of them are individuals who were provided with more than JD 9 million for building their personal houses (the Bank's *Annual Report*, 1988).

The share of financing extended to transport declined over the considered period, reaching only 4.7 per cent in 1988, compared to 13.7 per cent in 1984. This largely reflects the difficulties involved in trade with Iraq (during the Gulf War period), which most of the transportation companies were involved in. It is hoped that the ceasefire in the Gulf War will lead to an increase in demand for such advances.

The share of finance extended to services and other activities declined from 12.8 per cent in 1984 to 7.1 per cent in 1986 but then started to increase, reaching 11.5 per cent in 1988.

An obvious weakness of the Bank's financing policies is the shortcoming of advances to the agricultural sector, which is almost entirely neglected. The Bank extended no finance at all to agriculture over the first two years of its operations (according to its management), and advances to this sector over the 1984-1988 period were so small they were virtually negligible. Its share of the total financing only ranged between 0.5 - 0.6 per cent, which is even less than that of commercial banks, which ranged between 2.1 - 2.7 per cent of their total financing over the same period. This provides evidence that the Jordan Islamic Bank has taken no role in assisting small farmers, supplying them with neither funds nor means of production. It follows that the Bank has made no effort towards encouraging agricultural production for food security, as a real means towards a genuine economic independence for a country which suffers from a heavy dependency on the external world (see Chapter 5).

Given the Bank's investment policy, with its emphasis on short-term trade finance, as seen in the above presentation, it is clear that the Bank has adopted a "risk-aversion" approach, which is in contrast to the ideology of Islamic banking, based on "risk taking".

Faced with the above criticism, which reflects a discrepancy between ideology and practice, the management's response is that such a situation is not caused by ignorance or a lack of the Bank's commitment and responsibility towards society. It is the hostile and unencouraging environment with all its unfavourable implications that makes it very risky for the bank to invest its funds in medium and long-term projects. The highest level of risk is in agriculture, since its output depends greatly on the fluctuating climatic conditions of Jordan (the problems of agriculture in Jordan were detailed in Chapter 5). With reference to the Bank's policy towards agriculture, as compared to that of commercial banks, the General Manager of the Jordan Islamic Bank, Mr Mousa Shehada, argued that the comparison is somehow unjust. To him, the finances made by commercial banks are loans guaranteed and covered by strong security, so that it is the farmers who carry the burden (in case of loss) and not the banks. The General Manager commented:

> "The lack of honest and responsible entrepreneurs, with the required guarantee for conducting long-term business or offering agricultural finance, is a crucial obstacle for us,"
>
> "On the other hand, the Bank strategy towards the different sectors is, for the most part, influenced by the demand of the clients ... The Bank cannot force investors to undertake agricultural projects if they apply for funding for housebuilding or commerce."

On the subject of actively looking for such projects, Mr Shehada said that:

> "With the intention of enhancing our operations in this sector, we employed an agricultural engineer, but within two years he said that no fruitful or feasible project could be carried out in this field. Accordingly, he eventually gave up the job, and we then recruited another engineer, hoping to get some fruitful ideas or proposals."

Refering to the Bank's general performance under the current crisis of the Jordanian economy, he stressed:

> "At the end of what has been a difficult year (1988), our business is nevertheless in good shape. Our policy has been to expand when opportunities have arisen and this remains the case, but we are committed to increasing our research coverage to include all economic sectors."

(All the above statements of Mr Shehada were made in an interview with him conducted by the author in London on 2nd March 1989.)

8.6.4 Establishing and Creating New Employment Opportunites

Unlike many related aspects, the task of examining the role of the Bank in providing new employment opportunities in the country is rather difficult. Although the number of people who received funds from the Bank is estimated at about 10,000 in 1987, it is difficult to rely on one such number to precisely judge the Bank's role in initiating new jobs in the country. Neither the number of those people (professionals and entrepreneurs) who joined the business market for the first time, as a result of being financed by the Bank, nor the number of their employees, can easily be recognized. Moreover, the above mentioned figure does not exactly represent those who obtained the money for business. It also includes, as mentioned earlier, 4,500 persons who recieved funds for personal housebuilding purposes. This is in addition to an unknown number of those whose financing was concluded on a *Murabaha* basis for consumption purposes. What can be known exactly is the number of staff employed by the Bank itself in its wide network of branches. By the end of 1987, this number was around 450, representing roughly 5 per cent of total number of employees of the banking system in Jordan which reached 8,743 in the same year (The Association of Banks In Jordan, *Annual Report*, 1987).

8.7 The Jordan Islamic Bank's Contribution to Social Development

The social impact of the Bank's activities and financing can be seen in several economic, social and moral value-oriented measures as follows. First and foremost is maintaining social justice and prosperity by affecting the distribution of income in the society. The Jordan Islamic Bank has without doubt affected the distribution of income in Jordan by generating profits for a huge number of shareholders, depositors and investors. The aforementioned records of the Bank's revenues and the client numbers strongly confirm this argument. The contribution of the Bank to the redistribution of income can be seen in various ways. One important method is by providing income to the limited income group of small savers, who used to keep their money idle instead of depositing it in *riba*-banks, because of religious committments. The size of these saving deposits and part of investment deposits maintained by the Bank provide evidence for this claim. Other important ways by which the Bank can also contribute to the redistribution of income are the collection and payment of *Zakah* and the offer of interest-free loans (*Qard Hasan*). The achievement of the Bank in this regard should be examined in the light of the following points.

8.7.1 Maintaining and Enhancing Social Co-operation and Solidarity

This can be achieved by supporting the needy people through (a) collecting and distributing *Zakah*, (b) offering interest-free loans (*Qard Hasan*). Unlike the majority of Islamic banks currently operating in the world, the Jordan Islamic Bank has no authority to collect and distribute *Zakah*. According to Jordanian law, this function is restricted to the State Fund of *Zakah*.

At the same time, when the *Shariah* advisor was asked whether it was legitimate for the Bank to pay *Zakah* on the shareholders' funds on their behalf, the answer was negative. He emphasized that acting in this manner would contradict the recommendations of all Jurists (*fuqaha*) on the one hand, and bring about troubles on the other. He also added that,

> "it is safer and more rational not to issue any enactment for this purpose." (The JIB, The *Fatawa*, No. 2, 1987, pp. 13-15.)

Accordingly, nothing has been officially undertaken by the Bank in terms of collecting and distributing *Zakah*, although it is assumed that a large number of both the shareholders and the depositors will pay *Zakah*. No estimate of how much of the depositors' and shareholders' annual profits will be subject to *Zakah* can easily be made, because of the minimum-period condition of paying *Zakah* (the *hawl*).

As for its role in granting *qard hasan*, the Bank has initiated a special fund for this purpose, financed by both the Bank and benificiary deposits of the public. In 1985, the Bank started to accept *qard hasan* deposits, which must be specifically dedicated to help needy people, in order to alleviate social hardship. The maximum amount of a regular loan is JD 500, but in some exceptional cases it might be increased to JD 1,000. The development of *qard hasan* funding since 1985 is shown in Table 8.6.

From this table, it can be concluded that over the last four years the Bank has extended a remarkable amount of funding to needy people. Over this period, total funds of about JD 1.7 million were extended to 4,553 individuals. In addition, in 1988 a sum of JD 227,000 was declared as a donation from the Bank's own funds to cover the costs of the establishment of *al Rawdha suburb*'s mosque, including a flat for the *Imam* (who leads the prayer).

Although Islamic banks can be seen as financial enterprises rather than as charitable organisations, it is hoped that the Jordan Islamic Bank's management

Table 8.6 : The interest-free loans' fund in the Jordan Islamic Bank from 1985 to 1988 (JD 000)

Year	Balance	Funds Extended	Number of Beneficiaries
1985	14.6	238	595
1986	30.6	381	1,107
1987	21.0	523	1,421
1988	27	516	1,430
Total		1,658	4,553

Source: The Jordan Islamic Bank, *Annual Reports*, 1985-88

will enhance the Bank's role in many activities through which the public will benefit.

8.7.2 Providing Public Social Services (education, health care, etc.)

Given the dearth of economic resources in Jordan, as well as the cultural and moral barriers to economic development mentioned earlier, the Jordan Islamic Bank has given due attention to the development of human capital as a prime indication of social progress and as a vital means towards economic advancement. Since the start of the second half of the Bank's life, investment in the field of education has been the most prominent feature of the Jordan Islamic Bank's contribution to the socio-economic development of the country. During the period, the Bank has been keen to participate in establishing and furnishing educational institutions. These institutions include the Jarash Community College, Alquds Community College and Yarmouk University, to which the Bank has supplied about JD 2 million to cover purchases of needed equipment and furniture. More importantly, the Bank has also participated in setting up an essential and important Islamic educational project, to assist in creating a new generation who will be brought up in the noble principles and values of Islam. In 1987, the Bank was the major participant in a private shareholding company for nursery and elementary schools known as *al Madaris al Umariyya.* The Bank contributed 78.5 per cent of the company's capital, which amounted to JD 1 million. Such a project is indeed a significant step towards a fundemental structural change in the education system in Jordan.

Another important indication of the Bank's role in the provision of public services is its contribution towards improving health conditions. Despite the lack of data covering this issue, it has been emphasised by the Bank's management that the Bank has eagerly participated in supporting the health services in the country. In line with this, the Bank has financed the provision of laboratories and advanced equipment in hospitals, as well as highly specialized medical centres. This is in addition to contributing to the establishment of many medical and dental clinics and to financing the pharmaceutical industry.

8.7.3 Prompting Islamic Awareness of the Message of the Bank

This examines the Bank's role in prompting Islamic awareness and consciousness of the nature and advantages of Islamic banking on the part of the masses within the society.

Similar to most Islamic banks elsewhere, the Jordan Islamic Bank, in this field, has fallen short of the required goals. According to the Bank's management, the Bank is always trying to exploit any available opportunities; participating in conferences, seminars, workshops, etc. Some examples are the Bank's participation locally in seminars organised regularly by the Association of Banks in Jordan, a workshop on Islamic banking held in the al Albait Foundation in Amman in 1987, and the seminar on "The Practical Application of Islamic Banking" held in Amman in December 1988, under the supervision of the Arab Banks Union. Similarly, the Bank has participated in many activities abroad.

However, most of the above mentioned activities, if not all, are usually restricted to specialized academic and executive people and sometimes just the elite of the businessmen within the country. Thus, a lot is still to be done for the broader sectors of the masses in order to achieve two important goals.

i) To call forth proper Islamic awareness and consciousness of the nature and advantages of Islamic banking, and to remove any misgivings related to it. Also, to remove any misunderstandings among the clients of the Bank relating to the modes of finance it provides. According to the Bank's management, most of the operations performed by the Bank (mainly in the beginning) were not easily understood by the majority of its clients, and so were subject to the wildest misinterpretations. A very common example is that many people who approached the Bank to get finance for a business thought that *Musharaka* always meant a 50:50 sharing of profits.

ii) To help prompt a parallel campaign to the hostile one taking place against Islamic banking, fuelled by rumours resulting from ignorance. For further illustration, it can be said that Islamic banking still represents a new idea and faces hostile propoganda spread by many active in the international Arab media. So, the very demanding priority for any Islamic bank is to help confront the counter-information. The clear message to the Muslim masses in this field must be that Islamic banking is an important step towards ensuring prosperity and protection from exploitation. In other words, it is actually directly in harmony with their religion and morality.

8.8 The Suitability of the Bank's Personnel

At the outset, it must be made clear that a business' quality is judged by the quality of those who work for it. Thus, the quality of an Islamic bank's personnel must be regarded as its major asset, vital for any success hoped for by the bank. The key point of this success is the selection of the personnel from within such un-Islamically-oriented societies as those of the present-day Muslim world. Principally, people who join Islamic banks must enter totally into the spirit of Islamic banking and see it as part of a mission to form a better society.

Everyone who works in an Islamic bank must meet the following points in his/her personality, in terms of adherence to Islam:

- He/she must be a sincere Muslim who performs all the necessary duties towards Allah.

- He/she must have a grounding in the *Shariah.*
- He/she must represent the spirit and teachings of Islam in all aspects of dealing with the public.
- He/she must have the commitment, ability and enthusiasm to enable him/her to make every effort needed for success.

For the Jordan Islamic Bank, the selection of its staff and the unfamiliarity of Islamic banking to most of them (mainly in the early stages of the Bank's operations) represented a real problem, from which the Bank suffered a lot. Similar to all Islamic banks, most of the initial staff of the Bank came from other conventional banks and institutions in the Jordanian financial market; some of whom were enthusiastic about the new type of financial practices which were in harmony with their religious beliefs.

To compensate for the lack of people who have both the banking skills and the religious qualifications represented in the above conditions, the Bank has tried to cope with the available human resources as the *Shariah* permits. It started to build up its own terms upon which new employees are selected, as well as its own measures through which the existing personnel could be developed. Nowadays, the applicant's adherence to Islamic teachings and morality, as well as the awareness of Islamic banking, is a prerequisite for joining the staff of the Jordan Islamic Bank.

Equally important is the Bank's policy of "continuous education and training programmes". In an interview with the General Manager (London, March, 1989), he stated:

> "Our training policy aims at developing and up-dating the knowledge, skills and efficiency of our staff at all levels, in offering banking and financing services to the Bank's clients within the Islamic framework".

The major accomplishments of the Bank during its lifetime in this area can be briefly highlighted as follows:

- The Bank has co-operated with some other Islamic banks and financial institutions, receiving some of their staff and sending some of its staff to learn more about the different experiences of Islamic banks.

- In co-operation with local training institutions, one of which is the Banking Institute of the Central Bank of Jordan, a number of the Bank's employees have participated in training course, including Islamic banking. During 1986 and 1987, the number of employees who benefited from such courses amounted to 55, compared to 60 employees in 1988.

- Since 1986, the Bank has established its own Bank-based training centre. During 1987, three specialist courses were provided by this centre for the Bank's staff, on Islamic banking practices and techniques. This was increased to six courses in 1988.

- The Bank has also co-operated with local educational institutions, including universities and community colleges, and has offered traineeships in Islamic banking to a number of economics and business studies students. Some of these students have subsequently been recruited by the Bank.

- Scholarships in Islamic finance are also offered to outstanding students, and these are tenable at the University of Jordan on a sandwich course principle, combining academic study with practical training.

On the whole, if the above achievements are to be looked at with the realization that the Bank in this field is still in its infancy, they should be appreciated, but if they are to be judged in relation to what is hoped for, there is a lot still to be done.

Chapter IX

The Islamic Investment House: Its Rise and Collapse

9.1 Introduction

It has already been shown that after more than a decade of remarkable success, there are various signs now that Islamic business is moving into a challenging new phase.

The collapse of the Islamic Investment House in Jordan is undoubtedly an important example of such signs. This chapter, therefore, focuses on the rise and the collapse of this institution. Including this introduction, the chapter is divided into 6 sections. The second section will highlight the main legal and administrative features of the House, the third will provide an analytical examination of the sources and the uses of its funds. The investment policy, including the sectoral distribution of the House's investments and credits, based on published data will be examined in the fourth section. In section 5 the financial performance of the House will be assessed, mainly by using comparative ratio analysis between the Islamic Investment House and both the Jordan Islamic Bank and the Jordan Finance House. Finally, section 6 deals generally with the crisis of the House and its failure. This section will attempt to cover all aspects of the breakdown of the House, including case studies of some companies which were associated with the malpractices committed in the House's business. It will also end with the latest information about the settlement of the problem.

9.2 Preliminary Background

The Islamic Investment House was established on 10th September 1981 as a financial shareholding company registered under act No. 160 of the "*Companies Law*". It obtained a permit to operate from the Central Bank of Jordan on 28th September 1981 and was able to start its operations on 4th January 1982.

The authorised capital of the House was equivalent to that of the Jordan Islamic Bank with JD 4 million divided into four million shares. In total there were 4,430 shareholders; of these 4379 held 3,391,918 shares as individuals, while forty-one institutions held 608,082 shares. The majority of shareholders were Jordanians, but the shareholdings of foreigners (Arabs and non-Arabs) amounted to 25 per cent of the total issued shares.

The Islamic Investment House was founded as a result of a Kuwaiti initiative, with Mr. Tuhkaim Fahed al-Tukhaim as Chairman. Most of the directors were Jordanians, including Mr. Khairy Ayyoub al-Hammouri, who was a business man in Kuwait. al-Hammouri was appointed vice-chairman (the chairman later) and general manager of the Investment House.

The aims of the institution were similar to those of the Jordan Islamic Bank, in that it was intended to provide financial services for both investors and those in need of funds on a *riba*-free basis.

Indeed, the nomenclature "Bank" was avoided because of its connections with an interest-based economy. The goals and function of the institution were explicitly detailed in the Statute Bye-law and work regulations, which were drawn up even more meticulously than those of the Jordan Islamic Bank.

Although the Article of Association of the House stipulates that it may establish offices, branches and agencies in Jordan and abroad, the Islamic Investment House did not establish a branch network and its capacity remained restricted to its head office in Amman.

Similar to the Jordan Islamic Bank, the Islamic Investment House has a Board of Directors and a General Assembly. In addition they have a Shariah adviser, a position which Sheikh Mutlaq al-Muhtasib, one of the emminent Jordanian *Ulama*, was to hold. The characteristics and organization of the House were very similar to those of the Jordan Islamic Bank and, therefore, need not be repeated. Like the Jordan Islamic Bank the House operates according to the regulations of the Central Bank of Jordan and differs in its relations with the latter in only a very few cases, which will be shown later.

Relations between the Islamic Investment House and other Islamic financial institutions were almost non-existent. According to reliable sources within the Islamic Investment House the management of their organization has failed to build up a warm relationship with other Islamic banks, both locally and abroad. On one occasion, in the *al-Rawdhah* housing project (mentioned earlier), there was limited cooperation between the House and the Jordan Islamic Bank, but the latter had by far the larger role.

There were connections with the Kuwait Finance House, which was known to be one of the House's creditors, and whose debts amounted to JD 200,000 when the Islamic Investment House stopped operations in 1986, as will be discussed later. On the other hand the House established good relations with conventional financial institutions in Jordan, such as the Housing Bank and the Petra Bank. According to the House management, the total deposits of the two banks with the House amounted to JD 0.5 million in September 1986.

9.3 The Sources and Uses of the Islamic Investment House Funds

9.3.1 Sources of Funds

Similar to those of the Jordan Islamic Bank the financial resources of the Islamic Investment House consist of the shareholder's equity, deposits and other resources. The development of these sources of funds over the 1982-85 period is examined as follows.

1) Shareholder's equity:-

Shareholder's equity consists of the paid-up capital, reserves and retained profits. It is already mentioned that the authorised capital of the Islamic Investment House was JD 4.0 million. The issued capital was also JD 4.0 million. By 1985 only 96.3 per cent of the issued capital was paid-up, when the paid-up capital amounted to about JD 3.85 million. Unlike the Jordan Islamic Bank, the Islamic Investment House used to maintain two types of reserves:

i) The legal reserve which represents 10 per cent of the net profit. It was stipulated that the deduction of this reserve shall be continued until its accumulated value amounts to 25 per cent of the capital of the House.

ii) The voluntary reserve, which is determined by the management of the House. According to House law the annual deduction of this reserve must not exceed 20 per cent of the net profit and its accumulated total must not exceed half of the House's capital. In addition to the above reserves a proportion of the net profit, according to the House's law, may also be deducted as a retained profit, subject to the recommendations of the management.

The annual deduction of both the reserves and the retained profits, as well as their accumulated balances, are shown in Table 9.1. Having examined the data provided by this table the following points can be made:-

- The table shows that the House had met its obligation in maintaining a legal reserve of 10 per cent of its annual net profit.

- The voluntary reserve was deducted only in 1982 and 1983. While the formation of such a reserve under the difficult circumstances the House experienced in 1985 was necessary, the whole amount that remained after the deduction of the legal reserve was held as retained profit. This only can be understood as an attempt by the management to distribute high dividends in the coming years by adding this amount to any potential net profit, in order to prove a recovery.

- It can be seen from Table 9.1 that the total reserves and retained profits in 1985 exceeded the net profit realized that year; they amounted to JD 130,387 against JD 122,857; the difference covered by retained profits from previous years.

- A careful examination of both the balance sheets and the profit and loss statements of the House over the considered period shows that the accuracy and hence the reliability of the tables presented in these statements are questionable; one example is that there are items in a certain year, say 1983, which are relisted as a base for the comparison in the financial statements of the following year (1984), in values different from those presented in the former year. An actual example of this is the deduction of the retained profits, where the annual retained profits of 1984 appeared in the relevent profit and loss statement in the report of the year in question as JD 64231, but were relisted

Table 9.1 : The Annual reserves and retained profits of the Islamic Investment House, 1982-1985 (JD & percentage).

	1982	1983	1984	1985
Net profit	403,511	630,153	88,378	122,857
Legal reserve JD	40,35	63,15	58,86	12,28
%	10	10	10	10
Voluntary reserve JD	40,351	30,000	-	-
%	6.7	0.4	9.5	96.1
Total reserves&retained profits JD	107,697	95,751	116,74	130,387*
%	27.7	15.1	19.5	106
Accumulated balance JD	107,697	203,448	326,546	363159
Ratio to shareholder's equity	3.8	5.1	7.9	8.6
Ratio to total assets	2.5	2.4	2.5	2.0

Source : The Islamic Investment House,*Annual Reports*, (1982-85) Author's calculations.

in the financial statement of 1985 as JD 55,807. This also had affected the records of their accumulated balance in the balance sheet. Another example is that while the financial investment revenues realized in 1983 appeared as JD 712229 in the relevent profit and loss statement (of 1983) it was relisted as JD 778613 in the 1984's profit and loss account.

- While the ratio of total reserves and retained profits to total assets remained around 2.5 per cent over the period from 1982 to 1984 it fell 2 per cent in 1985. This decrease was a result of the decline in the realized profits.

- It appears from Table 9.2 that the shareholders equity was the main item of the House's over the first two years with 64 per cent and 46.6 per cent ratios to total liabilities in 1982 and 1983 respectively. With the expansion of the House's operations over the next two years the picture had changed and

Shareholders equity came second after the deposits when the former's ratio to total liabilities fell to 23.4 per cent in 1985.

Table 9.2 : The liabilities of the Islamic Investment House, 1982-85 (JD million & percentage).

	1982		1983		1984		1985	
	JD	%	JD	%	JD	%	JD	%
Shareholder's equity	2.82	64.9	3.99	46.6	4.10	31.6	4.22	23.4
Deposits	0.73	16.8	2.20	25.8	1.98	53.9	11.87	66.0
Bank deposits	-	-	1.00	11.7	0.50	3.8	0.15	0.8
Misc. Cash Margins	-	-	0.17	1.9	0.23	1.7	0.91	5.3
Misc. Provisions	0.20	4.7	0.34	4.0	0.32	2.5	0.26	1.4
Other liabilities	0.59	13.6	0.86	10.0	0.84	6.5	0.58	3.2
Total	4.35	100	8.56	100	12.97	100	17.98	100

% : The ratio to total liabilities.

Source : The Islamic Investment House *Annual Reports*, 1982-85.

2) Deposits:-

Deposits in the Islamic Investment House were almost the same as those in the Jordan Islamic Bank, except for a few differences. In the Islamic Investment House there was only one type of current account, a "demand deposit" account, whereas the Jordan Islamic Bank has both "current and demand deposit" accounts. No cheque books where given to the customers for the demand deposits and, until 1984, these deposits were considered merely as trusts. In the balance sheets of the institution they appeared along with the cash margins under one item (Amanat and miscellaneous cash margins). For the explanation of such an approach, which is not acceptable from the accounting point of view, sources in the institution mentioned that it was the suggestion of the Central Bank of

Jordan to adopt it. In addition, there were three types of joint investment:

i) Saving deposits, which participate in the realized profit with 60 per cent of its annual balance (note that this percentage in the Jordan Islamic Bank is 50 per cent).

ii) Notice deposits, which participate in the realized profits with 70 per cent of its annual balance (similar to that of the Jordan Islamic Bank).

iii) "Fixed deposits" where 90 per cent of their annual balance participate in the realized profits provided that the duration of the deposit is not less than a year (similar to that of the Jordan Islamic Bank).

The "specified investment deposits" received by the Jordan Islamic Bank did not exist in the Islamic Investment House. No data is available about the classification of the joint investment deposits into the three types provided by the institution. However, Table 9.3 shows the development of both demand and investment deposits over the years 1982-1985. In the first year of its operations the institution was not allowed to accept investment deposits. Therefore, the deposits of that year were only demand deposits, which amounted to about JD 0.73 million. By 1983, when the House started to accept joint investment deposits, demand deposits fell to about JD 0.67 million as some investors switched to profit earning deposits. However, in 1984 the demand deposits rose again, reaching about JD 0.87 million in both local and foreign currencies, and registering an annual rate of growth of 29.7 per cent, compared with -8.1 per cent in 1982. In 1985, however, they declined sharply to only JD 0.35 million, with a remarkable negative rate of growth of -59.7 per cent. As is shown in Table 9.3 this decline was in favour of Joint investment deposits. In 1983 these deposits started with JD 1.53 million, but increased to JD 6.11 million in 1984, an increase of almost 300 per cent in one year. Although this rate declined in 1985, when it reached 88.5 per cent, the total investment deposits amounted to JD 11.52 million. By the end of 1985 investment deposits became dominant, when its share of total deposits reached 97.05 per cent, whereas the share of demand deposits declined from 100 percent in 1982 to only 2.95 per cent in 1985 (Table 9.3). However, if the investment deposits of the Islamic Investment House are compared with those of the Jordan Islamic Bank they are insignificant; by 1985 the former represented only 14.5 per cent of the latter, which amounted to JD 79.11 million. Nevertheless, the total deposits of the Islamic Investment House increased remarkably during the 1982-85 period; Table 9.2 shows that their contribution to the total liabilities increased from only 16.8 per cent in 1982 to 66 per cent in 1985. However, if this ratio is compared with that of the Jordan Islamic Bank it is still low, since its first year of operations the latter's ratio exceeded 80 per cent (see Chapter 7).

Table 9.3 : The deposits of the Islamic Investment House, 1982-1985 (JD million).

	1982	1983	1984	1985
Demand deposits JD :	0.73	0.67	0.87	0.35
Their growth rate %	-	-8.1	29.7	-59.7
Ratio to total deposits %	100	30.42	12,5	2.95
Joint investment deps. JD:	-	1.53	6.11	11.52
Their growth rate %	-	-	298.5	88.5
Ratio to total deposits %	-	69.58	87.5	97.05
Total deposits :	0.73	2.20	6.98	11.87

Source : The Islamic Investment House, *Annual Reports*, 1982-1985.

3) Bank deposits:-

These represent the funds of both local and foreign banks, and of financial companies deposited with the House. The main purpose of these deposits is usually to facilitate the transactions of foreign trade. Table 9.2 shows that in 1983 these deposits amounted to JD 1 million but decreased to JD 0.5 million in 1984. In 1985, they also continued to decline until they reached JD 0.15 million. The share of these deposits in total liabilities also decreased from 11.7 per cent in 1983 to 3.8 per cent and then only 0.8 per cent in 1984 and 1985 respectively. This reflects the tendency of the House to pay less attention to finance transactions in foreign trade.

4) Miscellaneous cash margins:-

This item is also similar to that mentioned in the case of the Jordan Islamic Bank in Chapter 7. Table 9.2 shows that the fund of these margins increased from about JD 0.17 million in 1983 to about JD 0.91 million in 1985. Their contribution to the total liabilities however, decreased from 1.9 per cent in 1983 to 1.7 per cent in 1984, but increased again to 5.3 per cent in 1985.

5) Miscellaneous Provisions:-

This item consists of Investment risks provision and income tax provision. As is shown in Table 9.2 the funds allocated for these provisions increased from about JD 0.20 million in 1982 to JD 0.34 in 1983, but then started to decrease until it reached JD 0.26 million in 1985. On the whole, the share of these provisions compared to the total libailities also decreased steadily from 4.7 per cent in 1982 1.4 per cent in 1985.

6) Other liabilities:-

This includes other liabilities, such as bills payable, which amounted to about JD 0.38 million in 1982. The total funds of these liabilities increased from about JD 0.59 million in 1982 to about JD 0.86 million in 1983 but then started to decline until they reached JD 0.58 million in 1985. Over the reviewed period their contribution to the total liabilities also declined from 13.6 per cent in 1982 to 3.2 per cent in 1985.

The decline in these liabilities, as well as those insignificant liabilities mentioned above, reflects the change of the components of the liabilities in favour of the client deposits which comprised 66 per cent of the total liabilities in 1985.

).3.2 The Uses of Funds

Similar to any other bank or financial institution the uses of the Islamic Investment's funds are expressed in the assets side of its balance sheets.

The development of the various types of the House's assets over the 1982-85 period is shown in Table 9.4. A brief examination of these assets can be made as follows:

a) Cash in hand and at banks

As shown earlier, this item includes cash funds in the House's till, the cash reserve with the Central Bank and the balances with other banks and financial institutions. As can be seen from the Table 9.4 the cash items held by the House were relatively low compared with those of other banks and financial institutions in Jordan. While the ratio of cash to total assets in the Islamic Investment House amounted to 11 per cent and 13.5 per cent in 1983 and 1985 respectively, it was for the Jordan finance House (a parallel financial intermediary) 21.1 per cent and 28.4 per cent in the respective years. Although it is not intended to judge the financial position of the House at this stage, these tables give an indication that the management of the House was not cautious in their policy towards liquidity.

Table 9.4 : The assets of the Islamic Investment House, 1982-1985 (JD million & percentages).

	1982		1983		1984		1985	
	JD	%	JD	%	JD	%	JD	%
Cash in hands & at bank	0.99	22.7	0.94	11.0	1.77	13.7	2.43	13.5
Securities portfolio	0.46	10.5	0.56	6.6	0.50	3.8	1.87*	10.4
Investment in company capital	0.02	0.4	0.57	6.7	1.06	8.2	-	-
Financing investments	2.52	58.0	5.93	69.3	8.59	66.2	12.35	68.7
Fixed assets	0.25	5.7	0.34	4.0	0.65	5.0	0.70	3.9
Other assets	0.12	2.7	0.21	2.4	0.40	3.1	0.62	3.5
Total assets	4.35	100	8.56	100	12.97	100	17.98	100

* This represents securities portfolio and investments in capital of companies.

Source : The Islamic Investment House, *Annual Reports*, 1982-1984.

b) Securities portfolio/shares.

The Islamic Investment House used to deal in shares in the Amman Financial Market and other stock markets through middlemen. The development of its investments in securities is shown in Table 9.4. The values of securities held by the House increased from JD 456,267 in 1982 to JD 564,935 in 1983 but decreased to JD 499,001 in 1984. Its share to the total assets also declined from 10.5 per cent in 1982 to 3.8 per cent in 1984. In 1985, they appeared in the balance sheet, together with the investments in capital of companies, as an item which amounted to JD 1,872,703 and accounted for 10.4 per cent of the total liabilities.

c) Investments in Capital of Companies

This item represents the investments in the capital of independent projects and companies established on the initiative and with the support of the House. The total amount of the fund invested in this way increased notably from JD 18,406 in 1982 to JD 571,500 in 1983, which is more than a 30-fold increase. In 1984, it continued to increase, amounting to JD 1,057,648, and its share of the total assets also increased substantially when it peaked at 8.2 per cent in 1984 compared with only 0.4 per cent in 1982. In 1985, however, this item was listed in the balance sheet together with the securities portfolio as one item (as mentioned above) without any explanation provided by the House management for such an approach.

d) Financing Investments

This item reflects the contribution of the House in financing investments in different economic activities through the methods developed in the *Shariah.* Although the work regulations of the institution stipulated that the House may invest its funds through almost all the Islamic techniques of investment mentioned earlier, actually it adopted only some of them, as will be seen when discussing its investment policy later. However, financing investments enjoyed the lion's share among all other assets of the Institution. They accounted for 68.7 per cent of total assets in 1985 when they amounted to about JD 12.35 million against JD 2.52 million in 1982, when their share of the total assets was found to be 58 per cent.

e) Fixed Assets

With its head office in Amman, the value of the fixed assets of the Islamic Investment House increased from JD 248,492 in 1982 to JD 700,730 in 1985. The House's expenditure on fixed assets, if compared with those of the Jordan

Finance House, is very high; while the latter's expendings amounted to only JD 237,983 in 1985 (about 1/3 the House's) their ratio to total assets in 1984 amounted to 2.6 per cent compared with 5 per cent for the Islamic Investment House (See Table 9.4 and the JFH, *Annual Reports*, 1984-5).

f) Other Assets

The annual reports of the House provide no details about these assets. It is thus assumed that they are similar to those of the Jordan Islamic Bank mentioned earlier. Their total amount increased from JD 115,131 in 1982 to JD 623,243 in 1985. Their share of total assets also increased from 2.7 per cent to 3.5 per cent in the respective years.

9.4 The Investment Policy of the Islamic Investment House

The Islamic Investment House adopted a very ambitious investment policy from the early days of its existence. Unlike the Jordan Islamic Bank, it concentrated on financing long-term investment projects, as well as contributing to the capital of companies. Its tendency to invest its funds in long-term investments is reflected in the number of different methods of investment it adopted. Over the 1982-85 period, the average percentage of its financing and investment operation through these methods was as shown in Table 9.5.

As is shown in Table 9.5, the House concentrated its investments in *Mudaraba* and *Musharaka* which together accounted for about 70 per cent of the House's investments over the considered period. With such a high percentage of equity financing in a hostile environment like that of Jordan, the House can undoubtedly be labled as overambitious. In the absence of a definite collateral system and because of the fact that many of its investors had strayed from the right path of morality and adherence to Islamic principles, as confirmed by reliable sources in the House, the latter seemed to be heading towards a severe crisis. Many of the projects of both *Mudaraba* and *Musharaka*, which were originally the risk-bearing projects, achieved a loss, and many of the above investors avoided fulfilling their financial committments to the House. This was one of the most important factors that led to the crisis of the Institution, as will be shown later.

Table 9.5 : Types of investment methods of the Islamic Investment House, 1982-1985 (average percentages).

Type of investment	Percentage %
Mudaraba	40
Musharaka	30
Murabaha	10
Direct investment	10
Others	10
Total	100

Source : Provided by the Investment Manager after the collapse of the House.

As can be seen from the Table, the remaining 30 per cent of the House were distributed among the *Murabaha*, direct investments and others. When the Investment Manager* of the House was asked about the role of the House in establishing affiliated companies (interview in Amman, January 1988), he said that this kind of company did not literally exist in the law of the Jordanian companies. However, the House contributed to establishing many projects and companies, and helped to finance them. In this field, the House participated in establishing seven companies, whose capital was about JD 1.2 million of which the House contributed JD 0.6 million. This, in addition to participation in other companies, meant that the number of companies in which the House invested, was roughly fifteen with a fund of about JD 2.0 million. Of these, seven were classified as "short-term finance" to secure a semi-permanent income for the House, and the rest were long-term finance (Data presented here is also provided by the Investment Manager interview). More details about these companies will be given in the sectoral distribution of the investments of the Islamic Investment

* Mr Abdul Fattah Khalil, who was in charge of the Investment Department of the House before its collapse and was chosen by the Central Bank to cooperate with the temporary management in running the House and monitoring its affairs after the collapse.

House, which follows.

9.4.1 The Sectoral Distribution of the House's Investments

Since it started its operations, the Islamic Investment House tried to direct investment to all activities and sectors of the economy, including agriculture, industry, transport, real estate and others.

According to the fourth annual report of the House, the number of projects in which the House invested its funds during 1985 was 46, with total funds of about JD 3.5 million. The sectoral distribution of these investments is shown in Table 9.6.a.

Table 9.6.a : The sectoral distribution of the Islamic Investment House's investment in 1985 (JD).

Sector	Number of projects	Funds	Ratio to total funds %
Agriculture & land reform	15	1, 610,144	46.0
Industry	6	199,052	5.7
Trade	17	1,022,855	29.3
Services & construction	8	655,844	19.0
Total	46	3,487,895	100

Source : The Islamic Investment House, *Annual Report*, 1985.

It appears from the Table that a greater amount of funds was allocated to the agriculture and land reform, taking 46 per cent of the total funds shown in the Table. Trade came next, its share of the total fund amounting to 29.3 per cent, but industry received the lowest amount, only 5.7 per cent of the total funds invested in these sectors.

Approximate data covering the sectoral distribution of the House's investments over the 1982-85 period in an average percentage was provided by the Investment Manager, as shown in Table 9.6.b.

Table 9.6.b : An approximate sectoral distribution of the Islamic Investment House's investment, 1982-1985 (average percentages).

Sector	Percentage %
Agriculture	10
Industry	10
Trade	15
Real estate, transport & services	60
Others	5
Total	100

Source : Provided by the investment manager and the temporary management after the collapse.

In the light of the data provided by the Tables 9.6.a and 9.6.b, the House's investment in the various economic sectors can be examined as follows.

1) Agriculture

While agriculture's share in Table 9.6.a was 46 per cent, it was only 10 per cent in Table 9.6.b. Although the former represents 1985 only, whereas the latter covers the whole period under consideration, this huge difference between them remains an indication that the data provided by the House's annual reports may not reflect the reality. However, if even the 10 per cent ratio is considered, the contribution of the House to finance agriculture is quite remarkable when compared to that of the Jordan Islamic Bank or those of commercial banks mentioned earlier (see Chapter 8).

In this sector, the House participated in the capital of some companies such as "The Arab International Company for Agricultural Development" and "The

Vegetables and Preserve Company". It is also reported that the House had fincanced a plot of 1500 Dunums of water-irrigated land to be used for planting a variety of crops.

2) Industry

Unlike its contribution to agriculture, the contribution of the House to industry was clearly insignificant. It is shown that in 1985 only JD 199,022 were invested in industrial projects, which amounted to a mere 5.7 per cent of the total investments (Table 9.6.a). Also, if the 10 per cent shown in Table 9.6.b is considered, it is still low compared to that of the Jordan Islamic Bank. What needs to be noted, however, is that the House's investments were conducted for longer terms, as emphasised by reliable sources in the House. In line with this, the House had participated in the capital of two companies, namely, "The Jordan Steel Industries Company" and "The National Company for Cables Industry".

3) Trade

Through its investment in trade finance, the House intended to secure a semi-permanent income. Most of its investments in this field were carried out through *Murabaha* and installment sale. This is in addition to the participations in many companies such as "The Modern Commercial Markets Company", "The Jordan Center for International Trade" and "*Hawwa* Jewellers". The purpose of the latter was to buy and sell gold and jewels. The average share of trade investments over the considered period amounted to 15 per cent (Table 9.6.b). In 1985, however, this ratio was quite significant, as it was found to be 29.3 per cent.

4) Real Estate, Transport and Services

As a result of itemizing these three fields under one heading in Table 9.6.b, they occupied the largest average share of 60 per cent of the total investments over the 1982-85 period. Although it is difficult to estimate the figures separately for each of them, the contribution made by the House in this respect can generally be examined here. In terms of real estate, it is reported that the House financed the building of over 150 residential units in different parts of Amman, in addition to villas for rental in the Zayy and al-Ghour areas. The House also participated in a small way in financing the housing project of *Al Rawdhah* carried out by the Jordan Islamic Bank as mentioned earlier. In addition, the House contributed to the capital of some companies which served the real estate sectors such as " The Real Estate Investment Company" (ACARCO), "The Public Projects Company for Contracts" and "The Jordanian Company for Construction and Investment". On the other hand, the most significant investment of the House in terms of transport was its contribution to the ship, "*Farah*". As one of the major long-term investments, the House owned 30 per cent of this ship, which carries passengers, cars and trucks from Aqaba to other Red Sea ports, including Jeddah in Saudi Arabia and Nueiba in Egypt. In terms of services (mainly financial), an agreement was signed in 1983 between the Islamic Investment House and the Tukhaim International Exchange Company, which had its headquarters in Kuwait. According to this agreement, the Islamic Investment House was to manage this company in return for a share of its profits. The performance of this company and its relationship with the House will be a major concern in examining the collapse of the House later.

Under this policy of expansion of the Islamic Investment House's activities, it is surprising to discover that all these ambitious projects were supervised by its small staff of 15 in 1982, 35 in 1984 and 63 in 1986. This way of managing the business of the House will also be the focus of a detailed investigation later on.

9.5 The Financial Performance of the Islamic Investment House

9.5.1 An Introduction

The main objective of this section is to examine the financial performance of the Islamic Investment House in comparison with those of other financial institutions which have some features in common with the House.

Although, there is a great difference between the Islamic Investment House and the Jordan islamic Bank in terms of the size of their assets, it remains useful to examine the financial achievements of the former in the light of the latter's. The Jordan Finance House is perhaps the most appropriate choice for conducting a comparative assessment of its performance and that of the Islamic

Investment house. The Jordan Finance House was established in 1981 and started its operations in 1982 as a shareholding company with an authorized capital of JD 6 million. It is stipulated in the Company's law that it will conduct business according to the *Shariah* principles, although there was no mention of a *Shariah* authority to exist in the House (See the JFH, *The Contract of Establishment and the Articles of Association*, 1981). The annual reports of the Company, therefore, do not include any *Shariah* reports which would assure the conformity of the House's operation with the *Shariah*. Thus, unsurprisingly, it was reported that the Jordan Finance House, during summer 1987, had ceased its claim to be a *Shariah*-based financial institution. Since that date, the Board of the Jordan Finance House has decided to adopt conventional interest dealing and will no longer operate according to the principles of Islamic banking (see annual reports). However, since it was classified during the reviewed period from 1982 to 1985 as an interest-free financial institution, whose assets's size is closer to that of the Islamic Investment House, the Jordan Finance House remains the most appropriate institution upon whose performance the financial position of the Islamic Investment House can be evaluated.

The comparative assessment of the financial position of the three institutions thus will be based mainly on the financial ratio analysis which was used in the case of the Jordan Islamic Bank in the previous chapter. However, it may be useful to consider the sizes of some major financial items of each of the three institutions before conducting this analysis. When contemplating the data shown in Table 9.7, the following points are to be noted:

- In its fourth* year of operations (1983), the size of the Jordan Islamic Bank's assets was almost four times the assets of the Islamic Investment House in its fourth year of operations (1985) (ie JD 71.48 million against JD 17.98 million - see the Table). The Jordan Islamicce Bank also had more than six times the assets of the Jordan Finance House in the respective years.

- Based on the above comparason, while the deposits of the Jordan Islamic Bank were about five times those of the Islamic Investment House, deposits there were more than seventeen times those of the Jordan Finance House.

* The Bank started operations in September 1979, which means that the precise period it completed by the end of 1983 was three years and three months rather than four years.

- In 1985, the deposits of the Islamic Investment House amounted to more than three times those of the Jordan Finance House (JD 12.02 million against JD 3.37 million).
- While both the Islamic Investment House and the Jordan Finance House paid more attention to investments in shares, the amount of shares held by the Jordan Islamic Bank was quite insignificant; in 1985, their value amounted to only JD 0.3 million against JD 1.87 million and JD 1.01 million for the above respective houses.
- Although the total assets of the Islamic Investment House were, apart from the first year, larger than those of the Jordan Finance House, the cash assets held by the latter were substantially larger than the former's. This will appear clearly when examining the liquidity ratios of both of them later.
- With its operations being confined to its head office in Amman, the expenses of the Islamic Investment House in 1985 (JD 1.52 million) exceeded those of the Jordan Islamic Bank in 1984 (JD 1.42 million), which by the end of this year had twelve branches (including the head office) operating in various parts of the country. They were also about three times as large as those of the Jordan Finance House, which amounted to JD 0.57 million in the same year. This situation will also be reflected when measuring the efficiency ratio in the following analysis.

9.5.2 A Comparative Ratio Analysis

The purpose of this analysis is to assess the financial performance of the Islamic Investment House in view of those of both the Jordan Islamic Bank and the Jordan Finance House. It will be carried out on the basis of the published accounting data, which for the Islamic Investment House proved to be questionable, since the institution had already failed. Although this treatment does not attempt to develop a model to predict business failure, since the focus of the analysis is only on one failing institution, the study has benefitted a lot from the contribution made to the literature by many in terms of using ratio analysis in the prediction of corporate bankruptcy. Among these are the work of Beaver (1967 and 1968), Altman (1968), Deakin (1977), Ohlson (1980), and Bjork (1983).

In order to conduct the anlysis, some of the financial ratios which were used in the case of the Jordan Islamic Bank are also adopted here. They are also classified into five groups, examining the aforementioned financial objectives such as profitability, liquidity, etc. These five groups, including various indicators examining the financial position of each of the three institutions over the 1982-85 period, are shown in Table 9.8. Each of these groups can be briefly highlighted as follows:

Group 1 (*Growth*):-

The ratios adopted in this group indicate the annual growth rate of the most important financial aspects of each of the institutions, namely the assets, deposits and investments. From the Table, it can be concluded that:

- Apart from the growth rate of financing investments in 1984, the growth rates of all other financial items of the Islamic Investment House were always higher than those of the Jordan Islamic Bank. Two important reasons for such a situation are: (a) the insignificance of the items which belong to the Islamic Investment House compared to those of the Jordan Islamic Bank; (b) while the comparison is carried out for the 1982-85 period for both institutions, they, during this period, were at different stages of development.

- Apart from the growth rate of deposits in 1983, the growth rates of all other financial items were, for the Islamic Investment House, higher than those of the Jordan Finance House. The remarkable difference between the achievements of both reflects that, during its lifetime, the Islamic Investment House gained the greater confidence of the Muslim masses; the ambiguous stance adopted by the Jordan Finance House, in relation to its adherence to the *Shariah* principles, made it difficult for it to gain the same acceptability.

- Although there was a substantial difference between the growth rate of deposits and that of financing investment in the three institutions, the narrowest gap was that achieved by the Jordan Islamic Bank which even broke the rule when the growth rate of its investments exceeded the growth rate of its deposits. In 1984, for instance, while the growth rate of its deposits was 41.7 per cent, it was 67.2 per cent for financing investments. In contrast, while

Table 9.8 : A comparative ratio analysis of the IIH, JFH and the JIB, 1982-1985.

	1982			1983			1984			1985		
	IIH	JFH	JIB	IIH	JFH	JIB	IIH	JFH	JIB	IIH	JFH	JIB
Group 1 :												
Growth rate of total assets	-	-	43.1	96.8	60.3	58.0	51.5	13.4	42.8	38.6	12.0	24.2
Growth rate of total deposits	-	-	42.0	339.0	351.4	64.2	133.6	25.5	41.7	60.6	30.0	23.5
Growth rate of financing investments	-	-	86.4	135.3	109.3	42.2	44.9	10.1	67.2	43.8	11.0	12.6
Group 2 :												
N. prof. before tax / av. total assets	9.19	1.08	2.25	9.75	6.41	1.02	5.48	5.99	1.03	0.78	6.39	0.58
N. prof. before tax / av. total sh. eq.	14.18	1.32	23.52	18.53	8.59	13.7	14.6	9.04	19.44	2.88	10.5	13.49
Rate of return on deposits	-	-	7.20	9.00	8.00	5.40	9.25	8.00	5.70	-	8.00	5.50
Shareholders dividends	6.60	-	8.00	7.00	-	9.00	7.50	7.00	9.00	-	7.00	9.00
Group 3 :												
Liquid assets / total deposits	-	537	36.05	47.06	126.2	43.49	30.38	134.4	33.24	24.35	120.5	37.82
Liquid assets / demand deposits	200.34	1300	79.20	225.4	1733	124.0	260.9	1740	124.9	828.6	1962	164.9
Cash / total assets	22.76	34.16	28.29	10.98	20.71	36.01	13.65	25.68	26.99	13.52	28.35	30.65
Group 4 :												
Shareholder's equity / total assets	64.90	81.97	9.40	46.60	69.94	6.20	31.60	62.84	4.70	23.40	61.62	4.00
Shareholder's equity / total deposits	386.3	939.1	11.84	124.7	286.9	7.44	54.81	232.4	5.72	35.11	196.7	4.90
Shareholder's equity / total investments	97.2	137.6	16.11	56.50	98.17	11.70	40.40	89.72	7.61	29.6	90.32	7.41
Total investments / sh. eq.+inv. deposits	102.2	65.69	111.62	127.9	78.49	89.00	99.4	86.92	96.40	90.40	83.13	84.37
Group 5 :												
Credit facilities / total deposits	345.2	537	73.93	185.3	251	64.22	114.8	219.7	75.47	102.7	187.8	68.89
Total investments / sh. eq.+total deposits	84.4	66.24	66.54	98.3	75.5	60.24	87.65	77.93	71.79	87.62	73.40	65.95
Earning assets / total assets	68.90	59.58	61.60	82.60	71.24	57.40	78.20	70.04	67.50	79.10	68.22	64.20
Total expenses / net profit (before tax)	0.52	4.50	1.06	0.51	1.18	2.09	1.29	0.85	1.60	12.70	0.87	2.29

Source : Calculated by the author from *Annual Reports*, 1982-1985.

the growth rate of the Islamic Investment House's deposits in the same year amounted to 133.6 per cent, the growth rate of its investments was only 44.9 per cent.

Group 2 (*Profitability*):-

In this group, profitability is examined through four major ratios, the first two of them are the author's calculations and the others were given by the annual reports of the institutions. There are some important points which can be noted from Table 9.8 as follows:

- In the first two years of the considered period, the rate of return on total assets achieved by the Islamic Investment House was significantly higher than those of both the Jordan Islamic Bank and the Jordan Finance House. This mainly resulted from the huge difference in the assets size in the case of the Jordan Islamic Bank, but from the insignificance of the realized profits in the case of the Jordan Finance House (See Table 9.7).

- While the net profit/assets ratios of 1984 seemed to be a warning signal, when the Islamic Investment House was less than that of the Jordan Finance House, whose assets were less than the former (See Tables 9.7 and 9.8), the remarkable drop was that of 1985. In this year, the net profit/assets ratio of the Islamic Investment House fell sharply from 5.48 per cent in 1984 to only 0.78 per cent against 6.39 per cent for the Jordan Finance House. Given the huge difference between the Jordan Islamic Bank's assets and those of the Islamic Investment House as stated above, the comparison between the latter's ratio and the former's of 0.53 per cent is no longer valid.

- Apart from 1983, the net profit/shareholders' equity ratio was in favour of the Jordan Islamic Bank. This was due to the fact that the values of the shareholders' equity of the three institutions during the reviewed period were not so different from each other, whereas the profits achieved by the Jordan Islamic Bank were often higher than those of the two others. Generally speaking, this ratio also confirmed the previous one, concerning the severe decline in the profitability of the Islamic Investment House in 1985 as it amounted to only 2.88 per cent against 10.50 per cent and 13.49 per cent for the Jordan Finance House and the Jordan Islamic Bank respectively.

- The general ratio of return on deposits distributed by the Islamic Investment House in 1984 and 1985 was higher than those of both the Jordan Islamic Bank and the Jordan Finance House. While the latter's rate remains at 8 per cent over the last three years, it was 9 per cent and 9.25 per cent for the Islamic Investment House in 1984 and 1985 respectively. This is against 5.4 per cent and 5.7 per cent for the Jordan Islamic Bank in the respective years. From the above competitive rate of returns offered by the Islamic Investment House, the annual report of 1985 made no mention whether the House distributed profits to depositors or not. However, the House's share in revenues realized from investments was listed in the loss and profit account, although it was lower than that achieved in 1984. Similarly, depositors were assumed to have their share but not as high as the two preceding years. In 1985, the House also achieved losses in its investment in shares which amounted to JD 13,843 (*The Annual Report*, 1985).

- In contrast with the above, the rate of return distributed to the shareholders of the Islamic Investment House was less than that of the Jordan Islamic Bank but higher than that of the rate of the Jordan Finance House. With such a policy, the House attempted to attract depositors by offering them the higher rate of return and to compete with the Jordan Islamic Bank which was not likely to be affected by such competition.

Group 3 (*Liquidity*):-

Originally, the liquidity position is often examined by the first two ratios of this group, as shown in Table 9.8. However, since the magnitude of deposits of both the Islamic Investment House and the Jordan Finance House was not as big as that of the Jordan Islamic Bank's deposits, the above two ratios cannot be taken as reliable indicators to compare the liquidity position of these institutions. Accordingly, a third ratio was suggested to reflect the cash holdings in relation to the total assets of each of them. When examining the liquidity ratios over the 1982-85 period, given in Table 9.8, the following notes can be considered:

- In spite of the above reservation made on the liquid assets/deposits ratio, the first ratio of the group indicates that the Islamic Investment House was less liquid in 1984 and 1985. Of these, the lower liquidity ratio was that of 1985, which was 24.35 per cent - 5.75 per cent less than liquidity ratio described by the Central Bank.

- Given its large value over the considered period, the second liquidity ratio reflects that current deposits in both the Islamic Investment House and the Jordan Finance House are insignificant.

- It appears from the third ratio of cash/total assets, that the Islamic Investment House had experienced a difficult liquidity position over the reviewed period. While the ratio for both the Jordan Islamic Bank and the Jordan Finance House was often significantly above 20 per cent, it was 10.98 per cent for the Islamic Investment House in 1983, when the latter's investments registered their highest rate of growth of 109.3 per cent as shown in Group 1 of the ratios. Since the House concentrated its investment in financing long-term projects, through *Mudaraba* and *Musharaka*, such a low ratio of liquid assets to total assets meant that the House was over-exposed to high levels of risk; any business crisis or collapse of one or two large businesses in which it invested could result in its failure.

Group 4 (*Safety*):-

In this group four ratios were adopted to examine the safety of investments of the institutions in question. Based on the calculated ratios as shown in Table 9.8, there are some important points which can be noted:

- The substantial proportion of shareholders' equity to total assets in both the Islamic Investment House and the Jordan Finance House resulted in the first ratio of this group clarifying the nature of the two institutions as being investment companies rather than banks. For the Jordan Finance House, this ratio exceeded 60 per cent over the whole reviewed period (See the Table).

- With its excessive value (compared to that of the Jordan Islamic Bank), the solvency (shareholders' equity/total assets) ratio for both the Islamic Investment House and the Jordan Finance House confirms the above mentioned ratios, which indicate the insignificance of the deposits of the two institutions. While it was 35.11 per cent for the Islamic Investment House in 1985, it reached 196.7 per cent for the Jordan Finance House and only 4.9 per cent for the Jordan Islamic bank in the same year.

- From the safety margin ratio (shareholders' equity/total investments), it can be noted that the highest ratio margin achieved over the considered period was that of the Jordan Finance House. Apart from the first year, the highest point of its ratio was 98.17 per cent in 1983. This was against 56.5 per cent and 11.7 per cent for the Islamic Investment House and the Jordan Finance House respectively.

- The final ratio in this group which reflects the level of investment risks indicates that the highest level of risk was that involved in the investments of the Islamic Investment House. The highest point of the latter's ratio was that achieved in 1983, when it amounted to 127.9 per cent. Any excess over 100 per cent in this ratio means that the employed fund is beyond shareholders' funds plus investment deposits. When this took place, in the case of the Jordan Islamic Bank, in 1982 (when the relevant ratio amounted to 111.62 per cent), it was easily explained by having a liquidity/trust deposits ratio below 100 per cent, which meant that some of the trust deposits were utilized for investment purposes. However, this was not the case with Islamic Investment House; in 1983, the year in question, the liquidity/trust deposits ratio of the House was 225.4 per cent, as is shown in Table 9.8. Once again, this raises questions on the accuracy and the credibility of the published data provided by the annual reports prepared by the House management.

Group 5 (*Efficiency*):-

The indicators selected in this group generally show how well managements were putting their financial resources to work. From the comparison between the performance of the three institutions, the following points can be concluded:

- The first ratio of the group also confirms all the above ratios, which suggested the insignificance of deposits for both the Jordan Finance House and the Islamic Investment House.

- The second ratio indicates that the Islamic Investment House was the most efficient amongst the three institutions in allocating its available financial resources for investment. Its highest ratio was that of 1983 of 98.3 per cent against 75.5 per cent and 60.24 per cent for the Jordan Finance House and the Jordan Islamic Bank respectively.

- The third ratio in this group confirmed the result which was derived from the ratio in the previous point, indicating that the efficiency of the Islamic Investment House was higher than those of the other two institutions during the period under study (See Table 9.8). However, when considering the above argument made on the investment's risks ratio this efficiency of the Islamic Investment House also remains questionable.

- The last indicator of efficiency shows that the records achieved by both the Jordan Islamic Bank and the Jordan Finance House were more balanced and reasonable. While the high ratio of 4.5 achieved by the Jordan Finance House in 1982 was mainly due to the negligible amount of net profits it realized, the Islamic Investment House's ratio of 12.7 in 1985 reflects the extremely high expenses it maintained in that year (See Table 9.7). This phenomenon remains without interpretation until the crisis of the House is investigated in the next section.

On the whole, it can be concluded from the previous comparative analysis, which was based on published data, that the Islamic Investment House had generally enjoyed a reasonable financial position in both 1982 and 1984. In 1983, the House was over-exposed to investments and hence had a low liquidity position. In 1985, the intensified financial crisis which the House experienced resulted in a low profitability and insufficient liquidity. It was possible to get such results only from 1985 data because it was put through a relatively careful inspection, carried out by the Central Bank. However, if it is said that such a financial institution had fallen into bankruptcy, while its annual reports strongly proclaim its viability and success, this means that there is some sort of "invisible hand" which caused that collapse. It is undoubtedly this hand that prepared the reports that gave the unreal picture about the fortune of the House. The search for this "invisible hand" is the main objective of the following section which investigates the crisis and the failure of the Islamic Investment House.

9.6 The Financial Crisis and the Bankruptcy of the IIH

9.6.1 Introduction to the Crisis

Despite the continuous emphasis made by the annual reports on the success of the House, problems actually started to appear in 1983. However, the House was committed to the investments it was backing and did not want to let its clients down.

In 1985 there were copious indications that the House was tackling many serious problems. An important indication was the decision of the management not to distribute any profits to the shareholders. The inevitable end came in August 1986, when the institution found itself unable to pay the salaries of its staff, as a result of a very serious liquidity crisis. This, of course, led to the intervention of the Government and the Central Bank; accordingly, the institution was closed down in September 1986. A temporary committee was then formed by the Government, including a representative of the Central Bank, a representative of the Chamber of Commerce and Industry and the General Manager of the Jordan Islamic Bank, to manage the House and to monitor its affairs. Another three committees of inquiry were set up; two of which were martial. One year later, the members of the Board of Directors were detained for being responsible for the failure of the institution. After a short period, they were all released, except for the General and the Financial Managers.

During his visit to Jordan in the winter of 1987, the author conducted in-depth interviews with many people from the different parties involved in the problem. The prevailing theme among the members of the management and their associates* was to consider only the outside factors, such as the economic recession, which had affected the country since early 1983, and to which they attributed responsibility for their difficulties. Some of them believed that the

* Unfortunately, the author was not allowed to interview the general manager of the House since he was jailed during the author's field work visit to Jordan

collapse of the House was a result of a conspiracy planned by the Central Bank and the Jordan Islamic Bank as the sole rival of the House in Jordan.†

However, many reliable sources, especially the committees of inquiry, emphasised the internal factors, such as the mismanagement of the House, as reasons for its collapse. In this respect, various reports were prepared by financial experts under the supervision of the above committees. Although these reports were not made public, the author had the chance to procure a summary of them. As these reports were obviously reinforced by reliable data, their portrayal of the position of the House is essential to the study of the crisis and they will be the most reliable source for the following analysis of the reasons behind the collapse of the House.

9.6.2 Reasons Behind the Collapse of the Islamic House

In dealing with the Islamic Investment House, many trustworthy sources noted that both the General Manager and the Financial Manager had made it a "family business", whose prime function was to serve their own goals and the goals of their relatives and friends (interview with some of the employees of the House). This was also confirmed by the reports mentioned earlier. According to these reports:

> "... In reviewing the deeds of the aforementioned person [the General Manager] during the exercise of his authority, it seems that he did not maintain the correct balance between his rights and his committments, and did not behave in conformity with the law. This led him to commit many illegalities which contravened the following enactments: (a) the Companies Law, No. 12 of 1964; (b) the Banking Law, No. 24 of 1971; (c) the Foreign Exchnage Law, No. 95 of 1966; (d) the Banking Law, No. 52 of 1976; (e) the Statute By-law and Work Regulations of the Investment House; (f) the Instructions for the Licencing of Financial Companies issued by the Central Bank; (g) the instructions of the Central Bank organising the work of banks and financial companies; and (h) the banking traditions, as well as the Islamic *Shariah*."

The above illegalities were also perpetrated by the Financial Manager, as he shared responsibility for the violations along with the General Manager. In the words of many of the staff of the House, as well as the investigators of the financial authorities, the former was entitled to do every thing that the latter

† This was said by Mr Yousif Abdou, the Manager of the Jordan Center for International Trade, in an interview with him in his office in Amman in January 1988.

could in the institution, and both had personal control over every feature of the House's business. From now on they will be referred to as the "two managers".

For the convenience of the analysis, the major findings of the above reports, which were also supported by other parties involved in the crisis, can be considered under two major headings. Although all the misdemeanours committed by the two managers have their own legal aspects, it seems more convenient to place the emphasis on malpractices related to the investment policy and to examine them under the following two headings:ones:

9.6.2.1 Managerial and legal misdemeanours

It is reported that many of the actions carried out by the two managers were contrary to the procedures and the regulations of the House, as well as the very basic principles of accounting, management and banking tradition. They can be distinguished as follows:

- Although the number of the employees of the institution amounted to 63 in 1986, the General Manager always relied on a very small number of them in many of the House's engagements. His excuse for such behaviour that it was necessary to maintain the secrecy of the business of the House. Accordingly, a full but personal authorization was given to the Financial Manager, as mentioned earlier. He was empowered to monitor most of the investments, to manage the accounts of the Tukhaim International Foreign Exchange Company (which will be highlighted later) and those of both the foreign and local banks, and to record the earnings and the expenses of the institution. In short, he was authorized to direct all the administrative and financial matters of the House.

- In line with the above, it became apparent that the General Manager always tended to take decisions without consulting or conferring with other members of the Board of Directors. The only exception to this was his consultation with the Financial Manager.

- Another important characteristic of the mismanagement of the Islamic Investment House was the absence of any sort of comprehensive financial and administrative system. This can easily be seen in the way adopted by the

House to manage the different accounts and to carry out many of its investment operations, as shown in the relevant reports.

- Following the above, no job descriptions were developed during the lifetime of the Islamic Investment House. Hence, no work regulations or arrangements related to the personnel were formulated to define their duties, rights, ranks, promotion and the basis of their selection, as well as the basis upon which their salaries were determined. In contrast, salaries were always decided at the discretion of the two managers. This also applies to the annual increases in salaries, bonuses and holidays etc.

As they tended not to turn to either the legal or the *Shariah* advisors, many of the operations managed by the two managers did not satisfy the legal requirements. This was confirmed by many examples given in the relevant reports. One example was the operations of the "Sawaheri Institution", with more than fifteen transactions costing millions of JD. Generally it can be said that no contracts were implemented to document the operations. Only two contracts were implemented at the beginning of the dealings with the House, without the knowledge of both the legal and the *Shariah* advisors. The two contracts, therefore, were classified as superficial and false.

In the absence of a comprehensive financial and accounting system (as mentioned earlier), the two managers tended to restrict the partial application of regulations to the financial department; this led to many faults, manifested in:

- The accounting system of the company tending to be operated in a central way, unlike the situation in similar firms. While the financial department used to keep all the accounting books of the House, as well as recording and posting all entries, the other departments were not allowed to deal with any accounting issues.

- Adopting the manual accounting system in completing and posting entries, which hinders and slows the adjusting process and which cannot ensure accuracy of records and control. (A complaint related to this issue was voiced by some of the House's employees interviewed by the author.)

- Restricting the paying and drawing orders to the Financial Department, which led to the domination of this department over all decisions on funding investments, as well as over all aspects of expenses.

- Opening different accounts (debit and investment) in a way which contradicted all systems, regulations and banking traditions, in order to show a healthy, but unreal, financial position. In the case of the debit accounts, many were opened without any consolidating documents or guarantees. These yielded no income to the institution. In addition, many unreal investment accounts were implemented, such as *Mudaraba* operation No. 100-10-1116-85, and the *Musharaka* operation No. 5048-84. It is also found that these operations were originally registered as debit accounts.

- Recording illusory profits through deceptive and fictitious operations, in order to reflect a successful position for the company. It was noted that the recording of such profits always took place in the last month or even the last week of the financial and accounting year. Considering the nature, as well as the timing, of the actually realized profits, especially those of the *Mudaraba* and *Musharaka* operations, it can easily be understood that the record of these illusory profits was no more than an urgent plastic surgery operation on the financial statements which had to be prepared by the end of the year.

- Establishing many illusory and non-existant deposit accounts, to show an adequate position on liquidity. Some of these deposits were those of the Tukhaim International Foreign Exchange Company with the Petra Bank (JD 0.9 million); the dated entries of these deposits are shown in the relevant reports. It is worth mentioning, however, that the Tukhaim accounts were not balances in banks but were in fact failing investments and debts in Kuwait, whose recovery was to be difficult, if not impossible. As a consequence of this involvement, many of the aspects of corruption in the Islamic Investment House cannot be seen in isolation from the Tukhaim Company, which lies at the centre of the problems. It is essential, therefore, to examine the position of some of the companies involved in the problem, including the Tukhaim Company, to illustrate their links with the Islamic Investment House.

1) The Tukhaim International Exchange Company:-

The Tukhaim International Exchange Company was established in Kuwait in 1983. The intiative came from the General Manager of the Islamic Investment House, who proclaimed that the function of the Company was to facilitate the House's transactions, by dealing in foreign currencies and precious metals. However, the Company's role stretched far beyond this. It has been emphasised by the relevant reports that the real function of the Tukhaim Company was only to serve the interests of the General Manager and his relatives and friends. It is found that many of the Manager's clandestine and unlawful transactions were linked with the Tukhaim Company. The establishment of the latter did not conform with the acts, systems, and regulations of either Jordan or Kuwait. In this regard, the Company was first registered under the names of various people, including Tukhaim Fahid al-Tukhaim, his wife and his father, with capital of KD 0.5 million. However, after getting the license and permission to start operations, the capital was redistributed among a new group of people, according to a contract for a joint venture company. Among these was the General Manager of the Islamic Investment House, who owned 10 per cent of the paid-up capital, which amounted to KD 100,000 (according to the new contract). In addition, a business agreement between the Tukhaim Company (represented by Tukhaim Fahid al-Tukhaim) and the Islamic Investment House (represented by al-Hammouri) was enforced in December 1983. According to this agreement, the Islamic Investment house was defined as being responsible for the security of the relevant transactions and any loss which might occur to them. Moreover, the House was to pay all expenses and funds needed for the business.*

As stated earlier, transactions and operations carried out by the Company were evidently inconsistent with its basic objectives. While it was proclaimed that the key function of the Company was trading in foreign currencies and precious metals, it was, however, exploited for different purposes. Collecting deposits† from Jordanians working in Kuwait and carrying out motor-car deals in

* More details covering the establishment of the Tukhaim Company are given in the special report prepared by Mr Hilmi Marie, the Financial Manager appointed after the collapse, and also in the general report prepared under the supervision of the Central Bank.

† In its permission for work issued by the Kuwaiti Ministry of Commerce and Industry on the first of February 1983, it is stated that the company is not allowed to work on behalf of foreign banks or to perform any of the activities of these banks in Kuwait.

the interest of the General Manager and his allies were the mainstream businesses of the Company.

In spite of the significance of the business in which the Company was engaged, it was directed by a personal and spasmodic management. No organizational structure or accounting conventions and principles were followed for operating the business. In this respect, the Company used to keep different kinds of both official and unofficial accounting books, which contained different kinds of unilateral accounts. While The Tukhaim Company used to have four different accounts related to its relationship with Islamic Investment House, but the latter did not maintain the corresponding ones. Only one account was opened in the Islamic Investment House and managed by the Financial Department in an unusual way, which contradicted banking and accounting practices. In addition, there was no consistency in, nor were any adjustments made to, the records of the business carried out between the two institutions during the three year period of business. Nevertheless, the House management used to send a telex with the outstanding balance of their account, mentioned above, on the 31st December every year. In turn, the astonishing reply of the Tukhaim Company used to emphasize that the balance was always consistent with that which existed in their records. In such a situation, one can ask whether such a conformity of records could be achieved in such daily-moving accounts. It seems very doubtful, if not impossible. In this regard, it is worth mentioning that the blame must be placed on the account's auditor who did not ask for any correspondence over the long period of three years, and eventually ratified the ostensible consistency without any opposition or reservation.

Another important aspect of the illegality in the Tukhaim Company was the consequent withdrawal of funds by the General Manager of the Islamic Investment House for his own purposes without giving any disclosure for these personal withdrawals which amounted to JD 26,803.* As to the accounting treatment of this fund, it was recorded in the accounts of Mr Walid Ghazlan (the General Manager's son-in-law and an employee with the Tukhaim Company) in the Tukhaim

* The payments of this fund which entered the Manager's account were dated as: JD 15,000 on 29/7/86, JD 7,190 on 20/4/86 and JD 4,613 on 16/10/85. These payments were defined as transferred money from the Tukhaim Company, but in reality they were withdrawals afforded by Walid Ghazlan's account, whose burden was eventually placed on the Islamic Investment House.

Company, whereas in the Islamic Investment House in Amman it was registered in the General Manager's account No. 56160. This was in addition to another variety of withdrawals implemented under various names with the backing and approbation of the General Manager, who himself used to receive these funds, which amounted to JD 150,949. More details about the personal withdrawals by the General Manager and his relatives and friends will be given later.

However, for further illustrations about the Tukhaim Company and its involvement in many unlawful transactions, a case of another company which was also heavily involved in the matter must be highlighted as follows:

2) al-'Umi and al-Hammouri Company:-

al-Umi and al-Hammouri Company was a Kuwaiti company whose prime function was to deal in the transportation business. According to a joint venture contract, the owners of the Company and their shares in its capital were defined as Mr Muhammed Zafer Ayyub al-Hammouri 50 per cent, Khairi Ayyub al-Hammouri 25 per cent and Tareq Faiz Abdul Razeq 25 per cent.

Although the role of this company in creating and escalating the financial crisis of the Islamic Investment House was not less than that of the Tukhaim Company, the two managers tend not to mention it clearly in the House's records. Notably, such an attitude was aimed at restricting any achieved profits to al-Umi amd al-Hammouri Company instead of them being distributed to the Islamic Investment House. The illegality of many of al Umi and al Hammouri Company's operations was manifested in different ways. One example was its dealings with the Ship *Farah* project, mentioned earlier. The Company was known to be the agent who undertook the marketing of the tickets for the *Farah* in Kuwait. However, when its debit with the *Farah* project exceeded JD 100,000, a remedial action was taken by the General Manager of the House, when he opened a misleading *Mudaraba* account, under the name of Walid Ghazlan, to cover a payment of JD 39,600 to the ship project (The details of this illusory operation are given in the *General Report*, pp. 42-47.).

The Company was an influential partner in the undocumented motor-car dealings carried out by the Tukhaim Company. Among these dealings were: the export of Volvo motor cars sold to al-Nasr Jordan Company; the sale of motorcars bought from Jawad bu Khamis,* which cost KD 340,000, and other dealings whose funds amounted to KD 210,587. It is worth mentioning here, however, that these transactions were not covered by the required legal documents; furthermore, the major body of their funds came from the deposits collected by the Tukhaim Company in Kuwait.

Apart from its connections with the above motor car deals of the Tukhaim Company, al-Umi and al-Hammouri Company was also engaged in many similar transactions with other companies. Some examples of these are worth mentioning:

- It was found that the Shubaki and the Faqeer Company was provided by the Islamic Investment House with funds and motor cars for trading in Turkey, for the benefit of the al Umi Company. However, when these cars were confiscated in Turkey for being stolen, the Islamic Investment House paid the cost of them. Although no reference was made in the Islamic Investment House's records to say that this business was related to al Umi and al Hammouri Company, the records of the Shubaki Company revealed this fact. For further illustrations, the records of the Shubaki and the Faqeer Company confirmed that the latter had made an agreement with al Umi and al Hammouri Company to market motor cars (of the "Dove" make) in Turkey. It is added in the Shubaki records that three motor cars were despatched then to Turkey, but once they arrived there, they were confiscated by the Turkish authorities. Moreover, the latter appealed for the delivery of another ten motor cars claiming that all of them were stolen from Turkey. It is ridiculous, however, when one knows that the burden of such a futile and despicable deal was placed on the shoulders of the Islamic Investment House.

- Its connection with transactions carried out by al-Mu'iz Company. The latter was mainly established to help in eliminating the financial hardships of the al-Umi and al-Hammouri Company. However, it fuelled further corruption, which was manifested particularly in the motor car deals. This was in addition

* Astonishing details of this were given in various places in the General Report and in particular the pages 50, 185, 209.

to its connections to many unlawful deals implemented with the cooperation of others like the al-Hammouri office for transportation in Egypt and the Idris and Zayton Company.

Coming back to the unlawful actions carried out by the General Manager of the Islamic Investment House and others in realising their own goals on the one hand and infracting all banking, financial and accounting regulations on the other, some can be illustrated as follows:

a) Misuse of his position; the General Manager, Mr Khairi al-Hammouri, obtained several concessional direct credit facilities through three accounts:

- The trust account: This was opened on 15th August 1983. Frequently this account was marked as overdrawn with a balance which at one time reached JD 12,117. According to the relevant reports the sources of funds deposited in this account were undoubtedly questionable and belonged to the House rather than the Manager. Over the period from 1983 to 1985, this account was supplied with JD 361,690, of which JD 139,533 were defined as salaries, rewards, holidays, expenses, travel, ticket costs, profits of shares in favour of the General Manager.

- Debit account: According to the records, withdrawals started on the 3rd July 1982 with the sum of JD 3,000 until they reached JD 10,627 on 31st December 1982. Overdrafts also continued during 1983, until this account was closed on 31st December 1983, with an overdraft of JD 3,705 being transferred to the trust account No. 56/60 mentioned above.

- Personal loan (sulfa) account: Without referring to the General Assembly of the House or to the Central Bank or any of the relevant entities, the General Manager opened this account for himself with the agreement of the Board Of Directors. This, of course, was on the grounds that the members who agreed with him were promised the same facilities. Hence, on 10th August 1983, he granted himself JD 10,000 repayed on 23/9/85 as JD 6,000 in an entry in the trust account No. 56/60. Thus, the personal loan account resulted in a debit balance of JD 4,000 on 23rd January 1986.

Although less details about the uses of these funds were given in the relevant reports, the latter still reflect the Manager's tendency to focus attention on and to care for his own interests and those of his relatives and friends.

b) In addition to the above, the General Manager enjoyed many indirect financial advantages through implementing many illusory operations and entering as an undeclared partner into many agreements and contracts. Some important examples were:

- The *Mudaraba* operation No. 100-10-1116-85 under the name of Walid Ghazlan mentioned earlier.

- The Mudaraba operation No. 44/84-10 under the name of Dawud Hujayyier, details of which were given in the *General Report* (p. 48), the reports of the Central Bank, the auditor of accounts and the temporary management of the House.

- The promissory notes, endorsed by Tariq Fiaz Abdurraziq and registered in the account No. 173/84-20, for JD 50,000 (The details of this transaction were noted on page 50 of the *General Report*).

- The *Mudaraba* operation No. 153-10-1116-89 under the name of the Petra Petrol Station. The partners of this project exploited the easy funds they obtained for operating *Hawwa* Jewellery Stores to finance the petrol station. In this respect, a loan of JD 27,000 from the Jewellery Stores was given by Tariq Abdurraziq to his brother-in-law, Sulaiman Raghib al-Hussaini, in addition to more than JD 10,000 withdrawn by the former for his personal purposes (The details of this operation were given on pages 64-67 of the *General Report*).

- The *Musharaka* operation No. 5048/84 under the name of Muhammed Zafer al Hammouri which totalled JD 9,942.

Relevant to what has been stated earlier about the involvement of some members of the Board of Directors in many unlawful acts jointly with the General Manager, the case of one of them can be highlighted here.

Information about violations committed by Mr Rajih Mahmoud Khurais, a member of the Board of Directors, is worth mentioning:

- This member did not own the required number of shares to be a member of the Board of Directors.
- A sum of JD 30,000 was withdrawn to purchase land in Amman, registered in his name.
- On the 20th October 1982, he was given a sum of JD 5,000 as an interest free loan (Qard Hasan).
- He withdrew a sum of JD 18,932 as a personal withdrawl in cash.
- In order to pay the cost of some of his own shares in the Baituna and Akarko Companies, he obtained JD 4,176 of the House's funds. Of the latter, a sum of JD 1,790 was also transferred to his savings account No. 129/61. Furthermore, a sum of JD 5,799 of different currencies was transferred abroad.
- Despite his consistent absence from Board meetings he was awarded a sum of JD 2,250 for attending such meetings during the years 1982 and 1983.

He also withdrew a sum of JD 12,288 from the Tukhaim Company for personal purposes, but the burden was placed *on the Islamic Investment House.* This is in addition to many other illegal acts aimed at achieving his personal goals, but it is beyond the scope of this study to elaborate further.

).6.2.2 Misdemeanours related to the investment policy of the House

As mentioned earlier, the Islamic Investment House adopted an ambitious policy for its investments from the start of its operations. Many of its investors built up their hopes for the future on the outcomes of the seemingly promising investments of the House. Unfortunately, these hopes were soon shattered by the severe financial plight which led to the collapse of the House.

The mismanagement of the investments, and their diversion from the presumed and normal channels into bilateral and secretive grooves, represented the severity of the financial straits which the House found itself in. Thus, many aspects of mismanagement related to investment policy of the House can be highlighted as follows:

Investment policy adopted by the House management was no longer based on any kind of feasibility study. Setting up a specialist unit for investment appraisal researches was never considered by the General Manager. This was emphasised by those who were given the superficial responsibility for managing the Investment Department, when they were asked about this issue. In their words, (interview with the Investment Manager and other employees)

> "It was only in the late period of our operations that we tended to beg a consulting report from some experts in evaluating investments"

said the Investment Manager, who added that the institution was however unable to benefit from these consultations because: (a) many of these studies came a long time after the implementation of the investments. (b) Most of these reports were superficial and provided no useful suggestions to help in rationalizing the process of decision-making related to the investment policy. (c) The primarily negative attitude of the Management and its lack of regard for this subject meant that they did not implement any potential improvements suggested by such studies.

Thus, the investment policy of the Islamic Investment House was notably characterized by the absence of feasibility studies.

Accordingly, a haphazard investment policy was the preference of the House's management, regardless of the institution's goals and its financial capabilities. Hence, the selection and financing of investment was clearly carried out in a family way, merely aiming to satisfy the desires of the General Manager, his relatives and associates. A major body of financial facilities, therefore, was restricted to this group of people. Among those who enjoyed such facilities are the following:

- Mohammed Rushdi al-Hammouri: Without any guarantee or firm committment terms to fulfil his obligations this client was given a fund of ten operations, of which eight were *Mudaraba* carried out without any guarantee or security and without a feasibility study having been conducted. This is in addition to the unjustified movement of his overdrawn current, savings and debit accounts. Having examined these operations, it is apparent that their ultimate objective was to serve the personal goals of the client as well as those of the General Manager, rather than realizing any gains for the House.

- Walid Ghazlan: He was mentioned earlier as the General Manager's son-in-law and an employee of the Tukhaim Company. He withdrew from the House's funds JD 165,319, most of which was defined as being engaged in the motor car dealings mentioned earlier.

- Tariq Fayiz Abdurraziq: The financial facilities obtained by Tariq Fayiz Abdurraziq (also mentioned earlier) from the House amounted to JD 250,000.

In short, several people from among the General Manager's relatives and friends, whose names would fill many pages were given substantial financial facilities without any guarantees or collateral which would have been appropriate to secure the funds (Details covering these improper involvements were given on pages 75-140 of the *General Report*). In the light of such nepotism, friends and relatives of the General Manager were given facilities without any consideration of the real financial capacity of the Islamic Investment House.

In several cases, many of these facilities exceeded JD 100,000, the maximum amount of money allowed to be offered without getting the approval of the Investment Department of the House, this being on the recommendation of the Board of Directors. However, most of these facilities were undoubtedly extended without referring to the Board of Directors or the Investment Department or the Central Bank of Jordan. Among those who received such substantial facilities were the following:

- The Public Projects Company, whose direct financial facilities exceeded JD 1.5 million since early 1986, apart from the indirect facilities.

- The Sawahiri Commercial Institution whose direct and indirect facilities exceeded JD 1.7 million, distributed among different economic sectors.

- The non-resident Kuwaiti engineer, Hishari al Baddah (Motocafe Institution), whose facilities to finance a transaction in Iraq exceeded half a million JD.

- Omar 'Ata Yousif (al-Mu'iz Institution for Commerce and Transport) whose direct and indirect facilities exceeded JD 0.7 million.
- The Idris and Zayton Company whose facilities obtained jointly with the member of the Board of Directors, Jamil Idris, exceeded JD 300,000.
- The Kurd and Abdunnabi Company whose facilities exceeded JD 300,000.
- Rushdi Abdurrahman Odeh (Sharq al-Mutawasit Institution) whose facilities exceeded JD 280,000.
- The Ghunaim and Fannun Company and al-Waha Commercial Company whose facilities exceeded half a million JD.

Another kind of investment of the House which still, but only just, survives is worth examining. For this purpose a case study represented in the company of the Jordanian Center for International Trade can be briefly examined as follows.

The Jordan Center for International Trade*

The Company was established in 1983 with a capital of JD 4 million, divided into four million shares, but later this capital was reduced to only JD 1.7 million as a result of the failing records of the company since it started its operations. The main function of the company is to deal in both local and international trade, including all activities necessary for conducting such business.

The Company is managed by a Board of Directors consisting of seven members. These included Mr Khayri al-Hammouri (the General Manager of the House) as a vice chairman and the Jordan Islamic Bank as a member.

Although the contribution of neither the Islamic Investment House nor the Jordan Islamic Bank in the capital of the Company exceeded JD 10,000, the credit facilities they extended to the Company were quite significant. By the end of 1984, these facilities amounted to JD 524,000. On the other hand, the Company also participated in the capital of the Islamic Investment House as its securities portfolio included 229,412 of the House's shares, which were fully paid.

* Information about this company was obtained from its Articles of Association, the annual reports and an interview with the General Manager.

A quick look at the Company's annual reports, however, would clearly confirm what had been noticed by the author in his visit to the Company in Amman in January 1988, that it was, and perhaps still is facing a serious slump, which somehow reflects its failure. In the 1987 *Annual Report* of the Company, it was revealed that the price of its shares had sharply declined, as it ranged between JD 0.35 and JD 0.40. It is said that such a decline was a result of the management of the Amman Financial Market's decision to fix the opening price at JD 0.40, due to the reduction of the Company's capital, against JD 0.80 prior to the reduction. This, of course, helped in bringing about a further decrease in the share's value as no new buyers could be expected to enter the stock market, especially given the economic conditions in the country (Interview with Mr Yousif Abdou, the General Manager of the Company). Unsurprisingly, all the balance sheets of the Company over its life time (1983-87) indicate that the performance of the Company has always resulted in a substantial loss. From the start of the Company's operations until the end of March 1987, the accumulated loss of the Company amounted to JD 359,386. This is in addition to another JD 239,272 which included fines and financial penalties as well as exchange rate losses.

Now, if the investment policy of Islamic Investment House is to be assessed, it is quite obvious from the illegalities committed by the former management that this policy was no longer aimed at contributing positively to and enhancing economic development of the country. Official reports of the House furnished an illusory and over-estimated role of the latter in different economic sectors. However, the real situation revealed by the relevant reports, prepared by the committees of inquiry, confirmed the idea that these achievements were only in the reports and have never actually been realized. In fact, as explicitly shown earlier, the operating policies of the House were dedicated merely to personal goals which were of great benefit to many members of the former management.

A number of indications may serve to confirm the above argument but, fundamentally, three major ones can be highlighted as follows:

i) With its metropolitan headquarters in Amman the House established no branches in the rest of the country. Hence, no effort was made to extend the investment and banking facilities to rural areas in order to reach the small savers and investors outside the capital, Amman. Therefore, the institution disregarded one of the main objectives strongly recommended in the Five-Year Development Plan of the country as mentioned earlier. One conclusion that can be repeatedly drawn here is that the major concern of the House management was to enhance and promote personal earnings rather than to further economic development. In line with this, they found it sufficient to limit themselves to the main (and the sole) office in Amman, which represented their "central station", whose major function was to seize all the ostensibly profitable opportunities, with scant regard as to how this affected the rest of Jordanian society.

ii) Axioms suggested above can further be confirmed by examining the sorts of investment projects implemented by the House. In this respect, one may truly ask what contribution to development could be achieved through the introduction of a jewellery trade or financing American ice-cream stores with a fund of JD 140,000, what contribution can be attributed to many other consuming, luxurious and marginal economic activities launched by the House.

This also applies to the astonishing events mentioned earlier concerning motor-car dealings in Kuwait and Turkey and to the futile involvement in projects like the Jordan Center for International Trade or even the ship *Farah* project. It is perhaps surprising to consider that the prime function of the latter was based on the hope that many Arabs (mainly from Saudi Arabia and the Gulf states) would dispatch their cars, on their way to Jordan, on the ship. Such hopes, however, evaporated immediately since it is rare to see a non-Jordanian Arab car touring in Jordan.

iii) One final socio-economic indication may be touched on briefly. This is the role of the institution in the social development of the society. Indeed, the contribution of the House was questionable. Apart from the *Zakah* paid by the House, as the minimum duty in this field, if the interest-free loans extended by the House are examined the shortcomings of the House become immediately clear. During the period it worked, the House extended interest-free loans to 30 individuals only and no loan was to be in excess of JD 1,000 (the upper limit being specified by the House Statutes). Contrary to this, a member of the Board of Directors, however, was given a concesssionary loan of JD 5,000, a practice which directly violated the regulations and procedures of the House. Extension of concessionary loans was thus not impartial and favoured the top management, their relatives and friends at the expense of those who were in greater need of such funds. The House has, therefore, defeated its objectives by these malpractices and, more importantly, violated the superior objectives of Islamic economics highlighted earlier.

Since the lessons which can be learned from the collapse of the House will be demonstrated in the general conclusion of this study it may be useful to examine in the following section how the problem ended and what the recent developments in this matter are.

9.6.3 Epilogue

So far, the main concern of this chapter has been the examination of the experience of the Islamic Investment House and its collapse. However, some important questions related to this matter remain unanswered. What will happen to the General Manager and other people responsible for the previous malpractices, based on the outcome of the relevant prosecution? What will be the eventual status of the House, in other words, will it be liquidated or will it be acquired by another party? Will the shareholders and the depositors get back their money in full and what will be the future of the House employees?

To begin with, the trial of the General Manager and his associates, started in late November 1988. During the trial, the jury heard the bill of charges, which detailed the misdemeanours committed by them. However, the result of the trail has not been declared as yet.

Recent information from Jordan indicates that new start-up arrangements are currently taking place to form a new bank, which will be run according to the *Shariah* principles under the name of the Islamic National Bank. According to a very recent report made by the founders of the new bank, its establishment was based on the Economic Security Board's decision No. 20/88, issued on 24th. December 1988, and agreed upon by the Central Bank on 3rd. April 1989 (*the Founders Report*, 16 August 1989).

Under this state of affairs, assets and properties of the Islamic Investment House have been bought by a group of local investors who are seeking a fresh start through setting up such a new venture. It has been decided that the capital of the new company (the bank) must be increased to JD 6 million in order to meet the requirements of the Central Bank. Among the leading initiators of the new venture are the Bank of Jordan and the Association of Engineers, who share 43 per cent and 21 per cent of the Bank's capital respectively. This is in addition to other participants, including businessmen, banks and financial and non-financial institutions.

Following the subscription of the founders, the remaining shares are currently offered in the Amman Financial Market for public subscription.

Concerning the claims of the depositors of the Islamic Investment House arrangements were made to pay them their funds fully but in installments.* It was decided that these depositors have the right to subscribe to the shares of the new bank provided that two thirds of the value of the shares must be paid in cash and the other one third can be offset by the value of their (House) deposits remaining with the Bank. It was also agreed that the shareholders of the Islamic Investment House will be compensated with 20 per cent of the nominal value of their shares in the House, if the number of the latter was not more than 500 shares. Those whose shares exceeded this number will be compensated with only 10 per cent of the nominal value of their shares. It is also declared that none of the former shareholders of the House have the right to participate in the shares of the new bank. Arrangements also made to compensate all the employees of the House, who will be asked to tender their resignations, provided that they will be given the right to apply for new careers with the Bank equally with any other applicants.

While waiting for the final permission from the Jordanian authorities to commence operations, all preparations are currently being carried out carefully under the supervision of some leading bankers in Jordan, including Dr. Sami Homoud, the former General Manager of the Jordan Islamic Bank. It has been disclosed

* Information provided here was obtained from an announcement made by the initiators of the Islamic National Bank to the depositors of the Islamic Investment House on 5 July 1989.

that Dr Homoud will hold the reins of the management as General Manager of the Bank.

In spite of the difficult market conditions under the severe crisis currently affecting the Jordanian economy, it is widely hoped that such a new start-up may revive and breathe life into Islamic business, after the unfortunate collapse of the House.

Chapter X

Conclusions and Recommendations

For convenience of presentation, the conclusions and recommendations which emerged on the basis of this study can be divided into three major areas, as follows:

10.1 General Conclusions

1. In reviewing the literature of Islamic economics (Chapter 2), it has been shown that Islamic banking is an essential part of Islamic economics, which is also considered as an integral part of a coherent system covering all aspects of Muslim life. Consequently, any attempt to apply Islamic banking in isolation from this context would not yield any ideal results.

2. In addressing the Islamic view towards interest (Chapter 3), it has been found that the consensus of almost all Muslim *Ulama* is that interest is *riba*, which is prohibited in all forms and circumstances, despite all attempts made by many Muslim thinkers to legalize and justify it on various bases. It was also shown that interest was strictly prohibited in early Western economic thought. Based on recent data, it was also proven that interest has a dangerous effect in disrupting the moral and socio-economic structure of the society, through its destructive impact on both consumption and production.

3. In establishing the Islamic substitute for interest (Chapter 4), it was shown that the principles of profit sharing offer the best alternative in Islam. It constitutes the underlying model of Islamic banking, and provides a wide range of applicable and viable methods of finance in the very sophisticated contemporary financial sense.

4. In examining the performance of the Jordanian economy (Chapter 5), it was found that this is characterized by many unfavourable features, which contradict the philosophy of Islamic financial institutions. This has adversely affected the performance of those Islamic institutions that exist in Jordan.

5. The assessment of the financial and banking system in Jordan demonstrated that Jordan has one of the most developed banking systems in the Arab world. However, there was a failure to introduce techniques based on modern banking technology to help attract further domestic resources (ie providing cheque cards, 24-hour cash-dispensing machines, special schemes for small depositors, etc.). The allocation of commercial bank funds has not been in line with the development objective of the country, as they refrained from extending long-term advances. The specialized credit institutions also have not succeeded in filling the gaps for which they were created.

10.2 Conclusions and Recommendations for the Jordan Islamic Bank

To present results in a form appropriate for both executive and academic circles, the following order is adopted:

10.2.1 Achievements

The empirical study showed that in less than a decade the Jordan Islamic Bank has succeeded in establishing itself among the leaders of both conventional and Islamic banks, both in Jordan and abroad. In 1987, the Bank was classified as the third largest of the 17 commercial banks (excluding the Housing Bank) working in Jordan. In the same year, the same rank was also achieved within the Islamic banking movement, when the Bank came third after the Kuwait Finance House and the Faisal Islamic Bank in Egypt. With such a record the Jordan Islamic Bank was classified 85th of the top 100 Arab banks in the relevant year.

Despite the extremely unfavourable market conditions (marked by increasing competitiveness) under which the Jordan Islamic Bank operates, its greatest achievement has been to continue expanding in various aspects and to prove its viability.

During 1988, which will be remembered in Jordan as the most economically eventful of recent years, and even as a financial catastrophe, the Jordan Islamic Bank's deposits, investments and profits continued to grow significantly. The assessment of the Bank's market position showed that the Bank's market share in deposits in the private sector was 8.1 per cent (2.3 per cent above the average). This achievement indeed reflects two important facts: Firstly, the growing religious feelings of righteous Muslims, who in all circumstances, prefer to deal with Islamic financial institutions rather than *riba*-based ones. Secondly, the growing confidence of Muslims in Islamic businesses, which are still seen as workable and promising despite the collapse of the Islamic Investment House in 1986 in Jordan.

In fact, there are some important reasons which helped the achievement of such a successful position by the Jordan Islamic Bank, which can be summarized as follows:

- The compatibility of the Bank's operations with the belief of Muslims and their Islamic cultural heritage.

- Providing its clients with a range of good quality banking services, which are carefully designed to satisfy their particular needs.

- Offering a new and fair means of financing and investment, based on profit sharing and characterized by objectivity.

- Paying attention to needy people by granting them benevolent loans (*Qard Hasan*). Over the 1985-88 period, the Bank extended about JD 1.7 million to 4,553 persons on an interest-free basis.

- Financing projects of clients who have specific technical skills and experiences but lack funds. Funds extended to professional and private individuals accounted for 15.9 per cent of the Bank's financing operations in 1987.

However, in areas which benefit the economy and prompt economic development of the country, the Jordan Islamic Bank still has much to do. Most of the Bank's activities are concerned with short-term financing through the *Murabaha* arrangements, which accounts for more than 80 per cent of the Bank's investments in general. The Bank has not yet taken any active part in financing long-term investment projects.

A serious weakness of the Bank's financing policies has been the lack of funds allocated to the agricultural sector, which has been almost entirely neglected. Advances to this sector only accounted for around 0.5 per cent of the total financing investments of the Bank over the last five years. Other aspects of the Bank's shortcomings in this regard will be pointed out when highlighting the problems facing the Bank in the following subsection.

10.2.2 Problems and Difficulties

It was found that the hostile environment in which the Jordan Islamic Bank operates is the chief cause of any unpopular policies adopted by its management. The absence of an Islamic monetary authority within the country, combined with other factors emerging from this environment, have resulted in many problems and difficulties for the Jordan Islamic Bank, which can be briefly summarized as follows:

1. The failure of certain existing laws to facilitate the Bank's operations in an interest-based economy like that of Jordan, in order to enable it to meet the requirements of its clients. One example of this is the fees law, according to which the Bank must pay repeated fees, which in the case of the financing of housebuilding, amount to 16 per cent of the financing cost.

2. Unlike the Jordan Islamic Bank, *riba*-banks in Jordan have the privilege of benefitting from arrangements that encourage exports at a discount rate. This makes the financing cost for the Bank higher than those of *riba* banks who enjoy such a concession.

3. In the very nature of its operations, the Jordan Islamic Bank is deprived of facilities rendered by the Central Bank as the lender of the last resort. This has resulted in the Bank having to adopt the following strategies:

   - Offering finance on only a short and medium term bases.

   - Maintaining high liquidity as a precaution against any emergency, which hinders the investment of funds and reduces the income of both the Bank and its depositors.

- Depending on the deposits inflow when preparing the financing and investment plan, without taking into account any potential support from the Central Bank, since the latter offers nothing.
- Concentrating on *Murabaha* financing rather than *Musharaka* and *Mudaraba*, because of the high circulation of the *Murabaha* funds and the certainty of its profits.
- Neglecting vital economic sectors and activities, such as agriculture, when allocating investments, because of the high risk involved.

4. The lack of sufficient financial instruments through which the circulation of funds can be accelerated in order to secure liquidity and stimulate investments.

5. The adoption of a strict collateral policy, under which the Bank requires its clients to provide a substantial security, against any finance they obtain from it. This is mainly due to the procrastination of some clients in repayment of funds, and the situation is made worse because they benefit from the existing prosecution laws in Jordan, under which the Bank receives no reimbursements on its due funds during the trial years.

6. The Bank is also hindered by prevalence of the *riba* mentality within the financial and banking market. As a result, Islamic banking is still misunderstood among the population; the rate of return collected by the Bank on *Murabaha* operations is widely labelled as a disguised form of interest.

7. The Bank's policy of insuring the articles it finances with the existing insurance companies is not acceptable to many people, since the operations of these companies do not conform with the *Shariah* principles.

8. The lack of appropriate staff for running the business in accordance with the ideals of Islamic banking, particularly when the Bank commenced operations.

In addition to all the above, the Jordan Islamic Bank, like any Islamic bank elsewhere, is also hindered by many of the obstacles and barriers mentioned in Chapter 4.

10.2.3 Recommendations

With the Jordan Islamic Bank putting all the above problems behind and managing to expand its business successfully, it may be useful to recommend the following suggestions, which may help the Bank to maintain its position as a market leader and find appropriate solutions to the above mentioned difficulties.

1) The successful working of the Jordan Islamic Bank (compared to other banks in Jordan) has demonstrated the practicality and viability of Islamic banking in the country, so that it can be suggested that the most appropriate and perhaps the ideal solution to all forgoing problems would be the Islamization of the financial system of Jordan. The experience of both Iran and Pakistan has shown that it is feasible to eliminate interest completely from the banking system. To ensure success, however, the Islamization process should be extended beyond the banking sector to include areas such as insurance, re-insurance, underwriting, shareholding, direct investment, etc.

2) Failing to observe the above proposal, as is likely to be the case for an indefinite period, all banks in Jordan, whether they operate on interest-based or interest-free bases, must be accorded equal treatment by the monetary authority of the country. With the Islamic National Bank currently under establishment in Jordan, the need for setting up a separate supervisory department for Islamic banks within the Central Bank is urgent.

3) Until any of the above proposals are implemented, the monetary authority has to come up with solutions to the problem of existing laws, which hinder the Islamic banks' operations, as cited above.

4) The monetary authority must also find a solution to the problem of how the Islamic bank can benefit from the Central Bank as the lender of the last resort, within the Islamic framework. One suggestion which can be made in this regard

is that Islamic banks should be given interest-free loans from the Central Bank on the following criteria:

- The amount of credit interest due on the cash reserves with the Central Bank. Since the Islamic bank does not receive the credit interest due on these reserves, it has the right to be granted loans whose due (debit) interest can be offset by the credit interest payable on its reserves.
- The amount of interest-free loans extended by the Islamic bank to the public.
- The amount of finance extended by the Islamic bank to certain economic sectors or activities in line with the objectives of the development plan of the country.

5) For more development orientation, the Jordan Islamic Bank should increase its medium and long-term financing investments. However, given the high risks emerging from the recession under which the Bank operates in Jordan, this objective may be achieved through the following:

- Applying different rates for the distribution of profits between the Bank and the entrepreneurs financed by it, according to project type and maturity, to minimize the risk margin on the part of the Bank. For example, if a businessman approaches the Bank to get finance for an agricultural project, the Bank may ask for a higher share in the realized profits against the higher risk involved in the project, instead of rejecting the proposal. This can also be applied in case of longer term projects.
- Placing an emphasis on feasibility studies, by having a well-trained staff specialized in the appraisal, analysis and evaluation of projects.
- Extending finance to creditworthy and reputable clients who should not have any financial or moral problems.
- Encouraging the influx of more fixed-term deposits, which stay with the Bank for longer periods, and to allocate them to long term investments, taking into consideration the matching principle between periods of deposits and periods of investments.

- Formulating an approach for taking calculated risks; one suggestion that can be proposed here is to distinguish between the funds of shareholders, where a greater degree of risk could be allowed, and the funds of depositors, where it is necessary to minimize the risk.

- By the monetary authority allowing the Bank to issue medium and long term *muqarada* certificates (debentures). This will provide it with longer term funds that can be allocated to finance longer term projects.

- Establishing subsidaries and joint ventures specializing in financing medium and long term investments in productive sectors.

- Receiving incentives, protection and security from the monetary authority for long term investments. The Bank must be backed with a governmental guarantee for the repayment of long term finance extended to higher risk projects which the Government wishes to encourage.

- Securing liquidity of the Bank by the Central Bank in case of any problems, which may result when the Bank's resources are deployed in long term investments.

- By the Government making better statistical data about the agricultural and industrial sectors available, in order to allow better evaluation of investments in these two sectors, the Bank can be encouraged to carry out long term investments in them. Encouraging the Bank to invest more in these two sectors can also be done by exempting agricultural and industrial investments from the requirements of the liquidity ratios, or by guaranteeing them.

- Applying financial ratios (cash reserves, liquidity and credit facilities) to the Islamic Bank different from those of conventional banks. Since these ratios are in favour of the latter (Chapter 7) the monetary authority should either exempt the Islamic bank from these ratios or modify them.

6) The Jordan Islamic Bank must give special consideration to the most pressing socio-economic development problems of the least developed rural areas within the country. Among things that can be done for these areas are:

- Spreading the Bank's network to cover small villages, to help familiarize the rural public with the habit of saving, and of banking their savings instead of hoarding them.

- Introducing mobile units to collect deposits from villagers as with the "travelling banks" in many western countries and as adopted in Pakistan.

- Reinvesting savings collected from these areas in projects within them (ie specifying their savings to their investments). Since those Muslims living in the rural environment have a deep committment to their religious beliefs, there is a great opportunity for mobilizing savings and launching interest-free businesses successfully.

7) Relevant to the above, the Jordan Islamic Bank must pay special attention to financing small industries and artisans. It is true that exending finance to small units effectively is a difficult task for most banks in general, and the Islamic bank working as an *all-purpose* bank in particular, but it is necessary for the latter to have a hand in this matter. Perhaps there would be a greater degree of responsiveness by the Bank if it was approached by individuals and businessmen organized in cooperative units.

8) The Jordan Islamic Bank must establish a *Shariah* control board with at least three Islamic jurists and economists as members. This board must be represented in all stages of the decision-making process within the Bank. There are many leading Muslim scholars in Jordan who can be recruited for such a board. In addition to the traditional functions of this board (Chapter 8), there are two important goals which can be achieved by initiating it:

- Formulating a standard *Shariah* code which determines, for the Bank's staff, the permissible arrangements and operations that can be conducted by the Bank.

- Developing new permissible financial instruments, to meet the changing requirements of the Bank's clients.

9) There is a great need for the Bank to develop its own research and reference department including an efficient unit for investment appraisal. There is no short-

age of suitable researchers in Jordan to be recruited to join such a department. Through such a scheme, the Bank can achieve the following:

- Identifying the ever-changing financial needs of present-day society and suggesting innovations to keep pace with them.

- Developing investment appraisal criteria especially suited to help Islamic banks select projects worthy of support, including social costing systems and means of measuring social benefits in particular.

- Preparing a wide range of well-studied projects to be offered to those who wish to invest their funds but lack suitable opportunities.

10) Relevant to the above, more attention must also be paid to financing academic research and university students who specialize in Islamic banking and Islamic economics. This would help in developing useful researches and creating a nucleus of scholars and experts in this field.

11) Special attention should also be accorded to spreading knowledge and enhancing awareness of Islamic banking, and Islamic economics in general, among businessmen, scholars, university students and the pulic at large. To this end, mass media should be fully exploited; the press and television are particularly powerful in influencing public opinion. Thus, a well articulated publicity campaign should be drawn up and financed adequately in order to benefit from these effective media. The Bank may also set up a video production unit, through which tapes covering the Bank's message and operations can be made available to many people from different sectors. In addition, the Bank must further strengthen its relationships with Muslim scholars and thinkers who have sufficient influence and prestige to enhance the chances of success of the Bank by publicizing its message in mosques.

12) Winning popular support for the Bank can also be achieved by assembling some leading Islamic jurists, economists, bankers, businessmen and many respectful social figures in Jordan, who may advise on ways and means of improving the Bank's progress. For this purpose, the establishment of the Jordan Islamic Bank's Friends Society seems to be a relevant and useful proposal.

13) Since the Bank is not allowed to collect and distribute *Zakah* a substitute could be the establishment of a Current Charity Fund (*Sunduq al Sadaqa al Jariyah*). Through such a scheme, the Bank can collect charity (rather than regular *Zakah*) from those who wish to dedicate their donation to benefit needy people on a continuous basis. For launching such a scheme, the following points should be considered.

- Funds collected from this charity can be divided into two main pools; the first is to be deployed in investments in order to secure the fund's growth and the second can be granted as benevolent interest-free loans to needy people.
- Charity must be given a strong developmental context; it must be extended in order to render the recipient self-reliant, by making him productive and income-earning.
- For the Bank not to carry any financial burden, the cost of managing such a fund must be deducted from the fund's resources.
- In case the Bank or the charity scheme are liquidated, the outstanding money of this fund is to be transferred to the Ministry of *Awqaf* (public endowment).

14) Since the depositors of the Bank share in its profits and losses, it is recommended that, while elaborating suitabe systems for the activities of the Bank, they must be given a chance to participate in the discussions of the investment policies and plans of the Bank. In this respect, the Bank should invite depositors to attend regular or irregular meetings parallel to those of the shareholders. This will strengthen the links between the Bank and its depositors and increase their confidence in its strategies. However, to save cost and effort, attending such meetings could be limited to those depositors who have a minimum of JD 10,000, for instance, and whose period of deposit is one year minimum.

15) There is a great need for comprehensive training of the Bank's personnel, covering banking behavioural and juridicial aspects. Training courses launched by the Bank in the previous phase were basically limited to the banking issues.

16) The Jordan Islamic Bank must be allowed to set up its own Islamic cooperative insurance company to insure businesses carried out by the Bank.

17) The Bank must strengthen its relations with other Islamic banks, which would help in achieving the following:

- Suggesting profitable outlets for the surplus liquidity of the Bank.
- Assisting in the establishment of a secondary Islamic financial market.
- Co-ordination between the would-be *Shariah* supervision board of the Bank and those of other Islamic banks to exchange opinions for issuing *fatawa.*
- Exchange of legal views concerning legal problems which face the Bank, as well as any other suggestions relating to new modes of transaction contracts.
- Exchange of technical experience and qualified manpower between the Bank and other Islamic banks and financial institutions and taking advantage of the existing training centres for intensifying efforts in training the personnel of these institutions.

18) In the end, in order to realize any of the above suggestions, which are linked to the Government, the Jordan Islamic Bank must initiate a serious and continuing dialogue with the Central Bank or monetary authority of the country. the aim is to reach some clear-cut accord on this matter.

10.3 Conclusion of the Islamic Investment House's Study

From the previous analysis of the rise and collapse of the Islamic Investment House, the following conclusions can be drawn and lessons learnt.

1) At the outset, it must be made clear that the collapse of the Islamic Investment House by no means reflects the weaknesses or imperfections of Islamic economics and its ability to provide distinctive and efficient methods of investment. It should be recognized that there are three main elements which are relevant to the possibility of a business's (bank) failure; the integrity and efficiency of its management, the nature of its operations and clients (those who are financed by the bank) and the type of supervision exercised by the monetary authority over the bank's activities. These elements are essentially the same for an interest-based business and an Islamic business, and if sufficient care is not exercised in

regard to these elements failure will occur, irrespective of whether the business in question is based on interest or on profit sharing principles.

2) A conceivably unbiased conclusion of the study is that the main factors behind the failure of the Islamic Investment House were the malpractices committed by its management. Instead of being immune from vices, as might be expected from the leadership of an Islamic institution, the businessmen of the top management of the Islamic Investment House were involved in excessive levels of corruption, on a scale previously unmatched in any Islamic institution. They took hold of the reins without realizing that one's position, authority and power are, similar to one's property and possessions, divine trusts, violations of which amount to treachery. With their narrow-minded business mentality they only aimed at amassing money, without caring to avoid *haram*, or any prohibited means of earning. Moreover, they thought that once they run their pen through the words "in conformity with Islamic *Shariah*" in their annual reports, the institution and its operations will automatically revert to being Islamic.

3) Following the above, it can be said that the recession and the unsettled (external) economic and social conditions that prevailed in Jordan merely assisted in revealing and perhaps accelerating the crisis of the House, rather than creating it.

4) In the light of the collapse of the Islamic Investment House, a reconsideration of the common understanding of Islamic business, and how it can be truly *Islamic*, must be made. Elimination of interest and avoiding pork and alcohol trade are not the only features through which a specific poject can be classified as *Islamic*. Of equal significance are a variety of influences, like morality, virtuous attitudes and the willingness of the responsible people to serve Islam. These are important determinants of the degree of the Islamism of a business and their absence will definitely lead to a business failure.

5) Of paramount importance is the reconsideration of the task of the *Shariah* control boards within Islamic banks and financial institutions. In the light of the collapse of the House, a more accurate and all-embracing understanding of the meaning and function of the control boards is desparately needed. The role of the *Shariah* control authority must not be restricted to merely endorsing reports, as

it was in the case of the House, and still is in many Islamic banks and financial institutions. It is only the existence of a *Shariah* control board, which might extend its supervision to every aspect of the business, that can help to build up a clear demarcation between what is true and what is false. In the absence of real managerial, financial and banking control, the *Shariah* control remains the stronghold whose omission would hinder the path to truth and thus to survival.

6) Applying the above to the task of auditing, it should be noted how easy it was for accountants to assert the legality of the institution's activities and financial position, and to recommend the General Assembly to approve them. Auditors must not be consulted merely to ratify the financial statements internally prepared by financial institutions. In acting as financial advisors they must not be in the pockets of their paymasters, telling them what they want to hear. By so doing, they simply destroy the work of others in the profession.

7) The failure of the Islamic Investment House has clearly disclosed the fact that the monetary authority in Jordan was paying little attention to the effective control and follow up of its activities and operations. It was only in late 1985 that the first important inspection of the House's business was carried out, but by this time it was too late. The misleading records and accounts should have been investigated at a much earlier stage, before the abuses became irreversable.

8) With rumours spread all over the country, and even abroad, about the victimized savers and investors of the House, serious consequences naturally resulted. It is certain that this collapse has seriously damaged the reputation of Islamic business and demolished the confidence placed in it by Muslims, not only in Jordan, but also in other countries in which Islamic businesses have succeeded in achieving economic and financial take-off, seemingly without any major problems.

Appendices

Appendix A

Islamic Financial Institutions Over the World

Country	Name of the Institutions	Date of Establishment
Bahamas	Dar Al Mal Al Islami*	1981
	Faisal Islamic Bank	
	Takwa Bank	
Bahrain	Al Baraka Islamic Investment Bank	1984
	Bahrain Islamic Investment Company	1981
	Bahrain Islamic Bank	1979
	Fiasal Islamic Bank of Bahrain	1983
Bangladesh	Islamic Bank Bangladesh Ltd	1983
	Al Baraka Islamic Bank	1987
Cyprus	Kibris Islamic Bank	1982
Denmark	Islamic Bank International of Denmark	1983
Egypt	Nasser Social Bank	1972
	Faisal Islamic Bank	1977
	Islamic International Bank for Investment and Development	1980
	Several Investment Companies	1980s
Guinea	Faisal Islamic Bank of Guinea	1984

Iran	All banks, both national and foreign, have been operating on a profit sharing basis since	1984
Jordan	Jordan Islamic Bank for Finance and Investment	1978
Kuwait	Kuwait Finance House	1978
Luxembourg	Islamic banking system International Holding Islamic Investment House	1978
Malaysia	Bank Islam Malaysia Behard	1983
Mauritania	Al Baraka Islamic Bank	1983
Niger	Faisal Islamic Bank of Niger	1984
Pakistan	All national and foreign banks conform to profit sharing principles since	1985
Philippines	Ammana Bank	1982
Saudi Arabia	Al Baraka Investment and Development Co.	1982
	Al Rajhi Co. for Currency Exchange & Commerce	1978
	Branches of Dar Al Mal Al Islami	1981
	Islamic Development Bank	1975
Senegal	Faisal Islamic Bank of Senegal	19

Sudan	Al Baraka Bank	1982
	Faisal Islamic Bank of Sudan	1977
	Sudan Islamic Bank	1983
	Tadamon Islamic Bank	1983
	West Sudan Islamic Bank	1984
Switzerland	Dar Al Mal Al Islami (see Bahamas)	1981
Tunisia	Saudi Tunisian Finance House	1984
Turkey	Al Baraka Turkish Finance House	1985
	Faisal Islamic Bank of Turkey	1985
	Kuwait Finance House (Turkey)	1983
UAE	Dubai Islamic Bank	1975
	Islamic Investment Co.	1977
U.K.	Al Baraka International Bank Ltd.	1984
	Al Baraka Investment Company	1982
	Al Rajhi Co. for Islamic Investment	1980
U.S.A.	Al Baraka Bancorp (California) Inc	
	Al Baraka Bancorp (Texas) Inc	

*Dar al Mal Al Islami registered in the Bahamas but with operational headquarters in Geneva.

Source : Collected by the Author from several sources.

Appendix B

Interview Questions

This appendix includes a list of the main questions asked to both the Jordan Islamic Bank's management and that of the Islamic Investment House to cover their performance during their life time.*

B.1 Questions put to the Management of the Banks

i) Basic requirement:-

1. Could you please provide me with the following items if possible.

a) The bank's law and articles of association

b) The bank's annual rep orts covering the life period of operations

c) The organizational structure of the bank and the duties of its different departments and divisions.

d) All application forms for opening different types of accounts

e) All contract forms of conducting business with the bank

ii) The role of the bank in mobilizing financial resources

2. What are the types of accounts offered by the bank

3. What is the innovation of the bank in terms of offering new saving schemes within the banking system

4. To what extent was the bank affected by the competition of other banks and financial institutions in terms of attracting deposits

5. What is the distribution of your deposits among the different types you offer in both local and foreign currencies

* There were several further questions relating to the performance of the Jordan Islamic Bank and the collapse of the Islamic Investment House which were asked by the author over the period of his study through interviews, correspondence, telephone calls and fax, although they are not included here.

6. What were the reasons for the increase of your capital in 1986 (confined to the Jordan Islamic Bank)

7. What is the general trend of the movement of your shares in the Amman financial market (In the case of the JIB, this was followed by several questions related to the matter).

iii) The bank's investment policy and deployment of funds

8. What are the investment techniques adopted by the bank

9. What is the magnitude of each of these techniques in the bank's operations

10. What is the bank's innovation in this field i.e., has the bank developed any new investment modes. If yes what are they

11. Most of Islamic banks are currently overexposed to *Murabah* operations; if this is the case with your bank what are the reasons of this tendency.

12. Has the bank established any subsidiaries and joint ventures within or outside the country. If yes what are they?

13. Does the bank have collateral systems to secure its advances. If yes, please give some details.

14. Does the bank has any cases in which the clients defaulted. If yes what were the solutions for such cases.

15. Would you please provide me with data covering the sectoral distribution of the bank's investments. (This was followed by several questions stemmed from the information provided by the bank).

16. Does the bank provide any long term finance?

17. If not, what are the main reasons behind this policy

18. Does the bank have a department specialized in Investment appraisal and feasibility studies.

19. What is the approach adopted by the bank in evaluating investment projects.

iv) The bank's relations with other banks and financial institutions.

20. Does the bank deal with riba-banks in its operations, either locally or abroad.

21. If yes, does the bank earn any interest from such dealings.

22. If yes, how does the bank handle this interest i.e. is it added to the *halal* income of the bank to be distributed to shareholders and depositors or is it allocated to charitable purposes.

23. Does the bank have any business dealings with other Islamic banks or financial institutions either locally or abroad?

24. If yes, what kind of dealings are they; are there any investment projects which were carried out jointly by the bank and these institutions. If yes please specify.

25. Is the bank a member of the International Association of Islamic Banks.

26. If yes, in what way does this membership benefit the bank?

27. If not, what are the reasons which restrain the bank from being a member?

v) The bank's investments in the local market and abroad.

28. Does the bank invest any of its funds in any non-Muslim countries

29. If yes, what are these countries, and what are the fields of these investments as well as their scales.

30. Does the bank invest any of its funds in any other Muslim Countries.

31. If yes, what are these countries, and what are the fields of these investments as well as their scale.

vi) The profitability of the bank.

32. Does the bank have any investments which have incurred loss during its lifetime

33. If yes, what is the scale of this loss and to what extent has it affected the bank's performance.

34. Has the rate of return you offer on deposits ever been lower than interest rate offered by *riba* banks and financial institutions in Jordan.

35. If yes, to what extent does this affect the bank's ability to attract more deposits, and what are the main reasons behind this low rate of return.

36. If the increase of deposits compounds with the lack of investment opportunities are among these reasons, do you think to halt accepting deposits and have you ever done so?

37. There is a general feeling among Muslims nowadays that the achievement of profits is the chief goal of the Islamic bank irrespective of the real benefit of the society. What is your opinion of this and what is the case with your bank?

vii) The bank's role in social co-operation and solidarity.

38. Does the bank offer interest-free loans (*Qard Hasan*) to needy people.

39. If yes, what are the main sources of these loans.

40. What are the limits of an interest-free loan, granted by the bank

41. What are the main criteria according to which the bank decides to offer the loan.

42. Does the bank collect *Zakah* from the public and distribute it to needy people.

43. If yes, how does the bank assure that the *Zakah* goes to those who actually deserve it?

44. If not, what are the main reasons which prevent the bank from iniating a *Zakah* Fund.

45. Does the bank pay *Zakah* on behalf of its shareholders

46. If not. Why not?

47. Is the bank initiated or does it contribute to the establishment of any other social-oriented schemes?

viii) The Shariah Control Authority.

48. Is the *Shariah* Control Authority limited to a single adviser or a board?

49. If it is limited to a single *Shariah* advisor what makes the bank refrain from having a *Shariah* board?

50. What are the qualifications of the *Shariah* advisor(s)?

51. Where does the *Shariah* advisor/board derive his/it authority from?

52. Is the *Shariah* Control Authority represented in all departments and divisions of the bank?

53. If not, how does the *Shariah* Control Authority practice in auditing the operations of the bank?

54. If the bank deals with *riba* banks who does the *Shariah* Control Authority assure that the dealings with these banks are in conformity with the *Shariah*?

55. Are there any specific forms of transactions which are deemed unlawful from the viewpoint of the *Shariah* Control Authority of the bank, while it is allowed in other Islamic banks, and vice versa?

ix) The bank's personnel.

56. The lack of suitable staff for Islamic banks is one of the most serious problems facing these banks; to what extent does the bank suffer from this problem?

57. What is the approach adopted by the bank to overcome this problem?

B.2 The Islamic banks relation with the Central Bank of Jordan*

1. What is the legal position according to which the bank was established (e.g. has the bank been established according to a special low)?

2. What are the laws to which the bank is subject in its operations?

3. Is the bank exempted of any existing laws to which *riba* banks are subject in their operation?

4. What are the facilities and advantages extended by the Central Bank to *riba* banks whereas the Islamic bank is deprived from them?

5. Are their any credit facilities extended by the Central Bank to the Islamic Bank on interest-free basis?

6. What are the ratios to which the Islamic bank is subject in its operations?

7. Does the Central Bank differentiate between *riba* banks and Islamic banks in applying the ratios requirements?

8. Does the Central Bank have an independent department for the supervision of Islamic banking?

9. Does the Central Bank have the right to inspect the operations and records of the Islamic bank at any time it wishes?

10. Does the Central Bank have a *Shariah* Control Authority to supervise the operations of the Islamic banks?

11. Does the adoption of any new investment or banking instruments by the Islamic bank subject to the approval of the Central Bank on them?

12. Are there any obstacles from your point of view which particularly hinder the bank operations? Please specify.

* These questions were asked to both Islamic banks and the Central Bank management.

B.3 Questions about the depositor's behaviour in the JIB*

1. Do you ever save (or deposit) money with *riba* banks? If yes, then is it because of:

a) Higher interest rates

b) Safety

c) Accessibility to funds

d) Range of good quality services and facilities

e) Others. What are they?

2. What were the main reasons for depositing your money with this Islamic bank?

a) To avoid *riba*

b) High profit

c) Range of good quality services and facilities

d) The accessibility to funds

e) Others. What are they?

3. If your money incurred loss would you withdraw it from the bank?

a) Definitely yes

b) Maybe

c) Yes

d) This will not affect my behaviour

e) It depends upon the size of the loss

* These questions were asked to ten of the Jordan Islamic Bank's depositors who hold joint investment accounts.

Appendix C

Data used in the Financial Ratio Analysis

Table C.1 : Balance sheet of banks in Jordan*, 1987 (JD million)

	AB	PB	CAB	JKB	JNB	BJ	JGB	AJIB	BBME	BCCI	GB	BM	ALB	CB	RB
Assets:															
Cash in hand & at bank	210.7	105.1	29.9	35.9	29.6	28.4	30.7	60.3	21.1	35.1	9.5	20.6	11.0	22.4	4.9
Bonds & treasury bills	78.7	17.0	31.4	19.4	20.9	15.0	8.5	7.8	7.1	7.3	7.1	2.5	3.3	2.2	1.3
Investments in securities	3.2	10.0	2.8	2.5	2.6	2.3	1.9	1.0	0.9	0.2	-	0.3	0.2	-	0.4
Bills discounted	48.2	49.5	28.7	32.6	35.3	19.9	20.6	-	2.3	2.3	3.1	1.9	4.9	0.2	3.5
Loans and advances	270.3	91.0	69.2	56.8	48.3	52.8	47.9	39.3	44.3	25.2	31.8	16.9	21.5	15.2	2.4
Fixed assets	11.3	6.0	1.0	1.3	3.6	2.1	5.0	3.8	1.2	0.1	1.2	0.5	0.6	0.3	0.1
Other assets	13.4	12.0	5.4	2.1	4.3	1.1	5.8	1.3	0.7	1.0	1.6	0.2	0.6	0.7	0.4
Assets=liabilities	735.8	290.5	168.4	150.6	144.6	121.6	120.4	112.5	78.4	71.2	53.1	42.9	42.1	41.0	13.0
Liabilities:															
Demand deposits:	127.3	36.2	29.6	24.0	31.2	17.4	14.8	2.2	5.8	4.3	10.0	1.8	7.6	3.0	4.0
Saving,notice&fixed deps.:	503.2	166.3	96.4	98.2	76.8	68.9	75.8	61.9	60.2	49.2	34.0	28.0	22.2	25.4	2.7
Due to banks in Jordan	6.0	53.8	3.1	4.4	3.8	5.6	12.0	18.2	-	7.5	0.3	4.8	3.3	-	0.1
Due to banks abroad	4.4	-	2.7	2.5	0.2	-	-	12.3	0.3	0.3	0.2	0.1	-	2.0	0.5
Borrowing from banks	-	8.5	9.4	-	-	7.5	2.3	4.0	0.7	-	-	-	-	2.0	-
Cash margins	44.5	5.5	6.9	4.7	4.8	6.2	2.1	0.6	1.9	1.8	0.6	1.8	1.2	0.5	0.1
Provisions	7.8	2.6	4.8	2.4	2.9	2.2	2.7	1.0	1.9	0.7	2.0	0.4	1.3	0.7	1.0
Other liabilities	17.4	5.4	5.2	4.7	5.0	2.3	1.4	2.6	1.5	0.7	0.5	0.5	1.0	1.2	0.3
Paid up capital	12.0	5.0	5.0	5.0	7.1	5.2	6.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	3.3
Reserves & retained profits	13.2	7.4	5.3	4.7	12.8	6.3	3.3	4.8	0.6	0.9	0.4	0.4	0.5	1.2	1.0
Distribution account	-	-	-	-	-	-	-	-	0.5	0.9	0.1	-	-	-	-

* Both the Housing Bank and the Jordan Islamic Bank are excluded since the items of their balance sheets are different from the above items. Data from the Sarian-Jordan Bank's balance sheet is not available.

Source : Derived from *Annual Reports* of the Banks, 1987.

Table C2 : Profit and loss account of banks in Jordan, 1987 (JD thousand).

	AB	PB	CAB	JKB	JNB	BJ	JGB	AJIB	BBME	BCCI	GB	BM	ALB	CB	RB
Income:															
Interest received	42,719	22,739	10,113	9,676	9,709	8,131	8,281	7,780	5,639	5,307	3,442	2,771	2,521	3,358	635
Received commisions	5,663	3,511	2,187	1,611	1,779	1,298	1,827	537	972	549	663	277	594	292	120
Difference on F. exch.	2,088	1,024	349	139	297	114	357	206	364	384	-	129	15	161	10
Other income	372	262	146	88	239	132	137	439	60	52	848	3	28	5	710
Total income	50,842	27,536	12,795	11,514	12,024	9,675	10,602	8,962	7,035	6,292	4,953	3,180	3,158	3,816	1,470
Expenses:															
Interest paid	34,891	19,888	7,935	7,215	5,654	5,388	7,118	6,147	3,871	4,141	2,311	2,128	1,477	2,154	201
Commisions paid	-	-	-	-	-	-	-	-	2	-	-	-	-	-	-
General & adm. exps.	9,680	4,428	2,830	2,575	3,924	2,717	2,290	1,055	1,702	804	1,900	779	1,380	699	560
Depreciation & other exps.	3,082	1,168	1,175	169	578	162	527	443	596	265	702	162	105	175	25
Total expenses	47,653	25,484	11,940	9,959	10,156	8,267	9,935	7,645	6,171	5,210	4,913	3,069	2,962	3,028	787
Net profit before tax	3,189	2,052	855	1,555	1,868	1,408	667	1,317	864	1,082	40	111	196	788	689

Source : As in Table C.1.

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